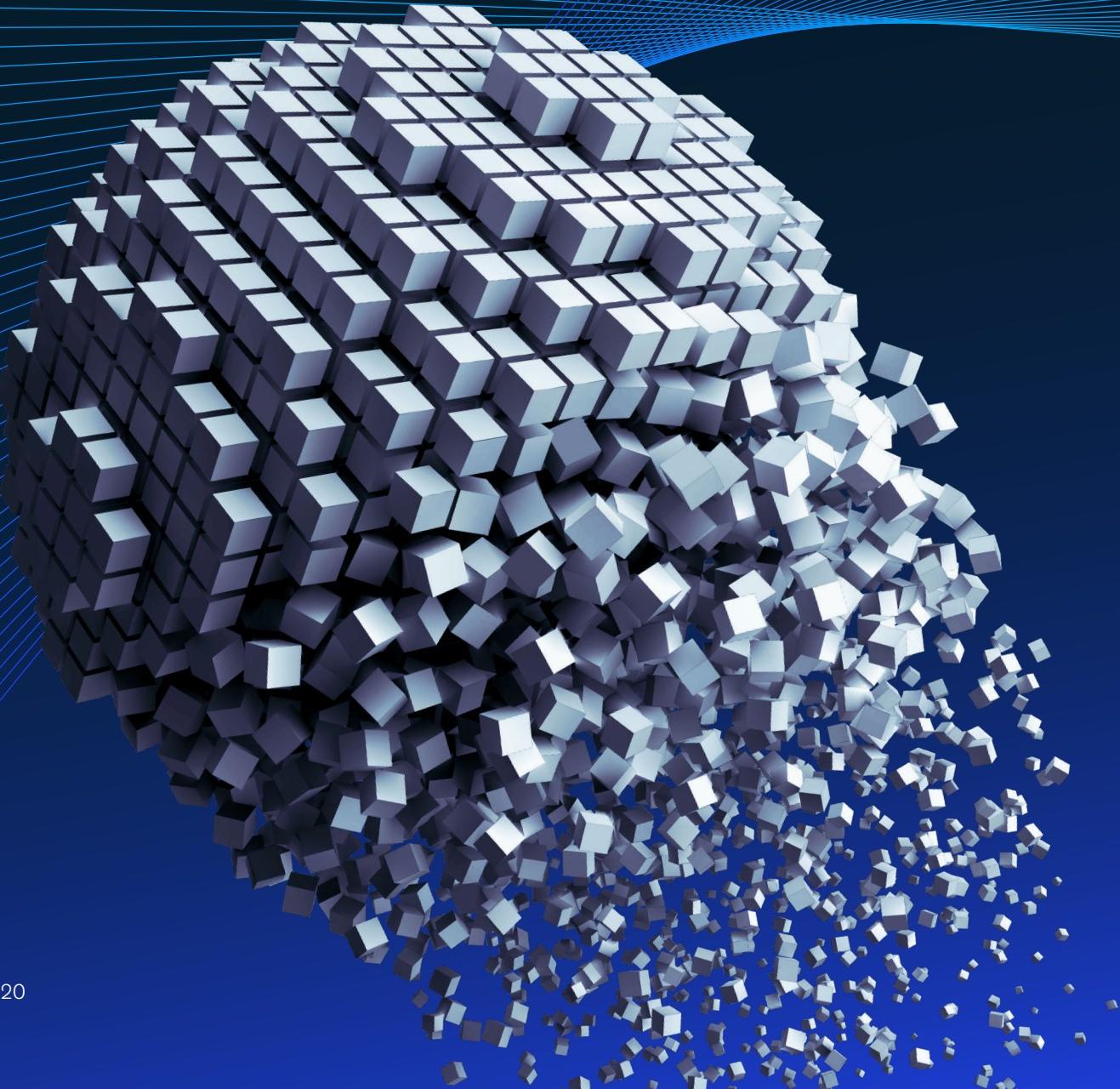


McKinsey
& Company

Global Banking Practice

The 2020 McKinsey Global Payments Report



Foreword

The public health crisis triggered by COVID-19 has had an impact on nearly all aspects of daily life for people across the globe, and has put the world economy on an uncertain footing. For the payments industry, the pandemic and its consequences have accelerated a series of existing trends in both consumer and business behaviors, and introduced new developments, such as a restructuring of both supply chains and cross-border trade. Ongoing shifts toward e-commerce, digital payments (including contactless), instant payments, and cash displacement have all been significantly boosted in the past six months. And while a degree of reversion to past behavior is likely for some of these shifts, the overall trajectory for these trends has received a strong push forward. Overall, the crisis is compressing a half-decade's worth of change into less than one year—and in areas that are typically slow to evolve: customer behavior, economic models, and payments operating models. As with most structural shifts, challenges will inevitably arise.

The impact of the crisis has not been consistent across sectors or geographies, of course. Travel and entertainment, which had been among the most advanced e-commerce sectors, was hit particularly hard and faces an uncertain path to recovery. Payments providers in regions that have lagged in digitization, meanwhile, in many cases possess greater potential for revenue increases in the new environment. On the other hand, a protracted period of low interest rates, which began before the current crisis, will pressure payments revenues, as will a persistent slowdown in economic activity.

This is the context in which we release our annual report on the global payments industry. As always, these insights are informed by McKinsey's Global Payments Map and by continuing dialogue with practitioners throughout the payments ecosystem.

Given the impact of the changes and challenges in 2020, however, we are taking a different lens to our analysis, focusing more on the current moment and on the future, than on examining past growth. Our first chapter briefly tells the story of 2019—a

solid year with broad-based revenue growth—but focuses primarily on current developments and takes a forward-looking view of the payments landscape. It also details the actions we believe payments providers will need to take to weather the pandemic and position themselves for the “next normal.”

Our “now-cast” analysis of 2020 paints a contrast between the first and second halves of the year—namely, an estimated 22 percent payments revenue decline in the first half will be softened somewhat by stronger performance in the second half. Still, we expect full-year 2020 global payments revenue to be roughly 7 percent lower than it was in 2019—a \$140-billion decline roughly equal to recent years' annual gains, and 11 to 13 percent below our pre-pandemic projection. Beyond this, in some countries and segments, the likely sustained increase in digital penetration could result in a recovery of revenue pools to levels matching our pre-COVID-19 expectations for 2021.

In following chapters, we explore four areas of payments we consider critical to achieving success in the context of accelerated change. Like many aspects of payments, the merchant-acquiring business was already undergoing significant transformation. Consolidation had driven scale economy imperatives, and non-bank market entrants were gaining inroads with underserved verticals. Our experts detail the need to redefine acquiring offerings to encompass a full suite of value-added services extending well beyond payments settlement—including fraud controls and cart optimization for the fast-growing e-commerce segment. In a separate chapter we look at the specific opportunity for small- and medium-size enterprises, a segment that has historically been expensive to serve for large incumbents, but which has been the focus of many fintech attackers and is well overdue for a closer look.

Supply chain finance has long been considered to be a source of untapped value, but unlike other payments sectors, has struggled to develop enough momentum to address its structural challenges.

Given an expected increased focus on working capital, a step change in digital adoption at scale, and the potential geographic re-shuffling of roughly \$4 trillion of cross-border supply chain spending in the next five years—the value embedded in supply-chain finance will become even more attractive. The question is whether it will be enough to spur a long-anticipated transformation.

Finally, in this overview of global payments, we look at a challenge many established payments providers are facing—the need to transform the

operating model to meet the growing imperatives for efficiency, scale, modularity (e.g., Payments-as-a-Service), and global interoperability. With many banks likely unwilling to commit the hundreds of millions of investment dollars needed to modernize existing payments infrastructure, we outline various paths worth considering before more focused players can establish an insurmountable advantage.

We hope you find the insights in these pages thought-provoking and valuable as you navigate these uncertain times.

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The accelerating winds of change in global payments

The COVID-19 crisis is having a significant and widespread effect on global payments across sectors. The most striking and potentially lasting impact is an accelerating pace of change in the industry.

Philip Bruno

For the global payments sector, the events of 2020 have reset expectations and significantly accelerated several existing trends. The public health crisis and its many repercussions—among them, government measures to protect citizens and rapid changes in consumer behavior—changed the operating environment for businesses, large and small, worldwide. For the payments sector, global revenues declined by an estimated 22 percent in the first six months of the year compared to the same period in 2019. We expect revenues to recover (only to a degree) in the second half of 2020, ending 7 percent lower than full-year 2019. Over the past several years, payments revenues had grown by roughly 7 percent annually, which means this crisis leaves revenues 11 to 13 percent below our prepandemic revenue projection for 2020.

Given the impact of COVID-19 on the operating environment, we are diverging from our usual approach of delivering perspectives on the current year's global payments landscape relative to the prior year. Instead, we focus primarily on the state of the payments ecosystem in 2020 and explore the actions payments providers need to take to compete effectively in the "next normal."

The insights in this report are informed by McKinsey's proprietary Global Payments Map, which for over 20 years has provided a granular, data-based view of the industry landscape.

A half decade of change in a few months

For global payments, 2020 stands in dramatic contrast to the year before, which was a relatively

Olivier Denecker

Marc Niederkorn

stable year. Global revenues grew at nearly 5 percent in 2019, bringing total global payments revenue to just under \$2 trillion (Exhibit 1). Payments also continued to grow faster than overall banking revenues, increasing its share to just under 40 percent, compared with roughly one-third only five years earlier.

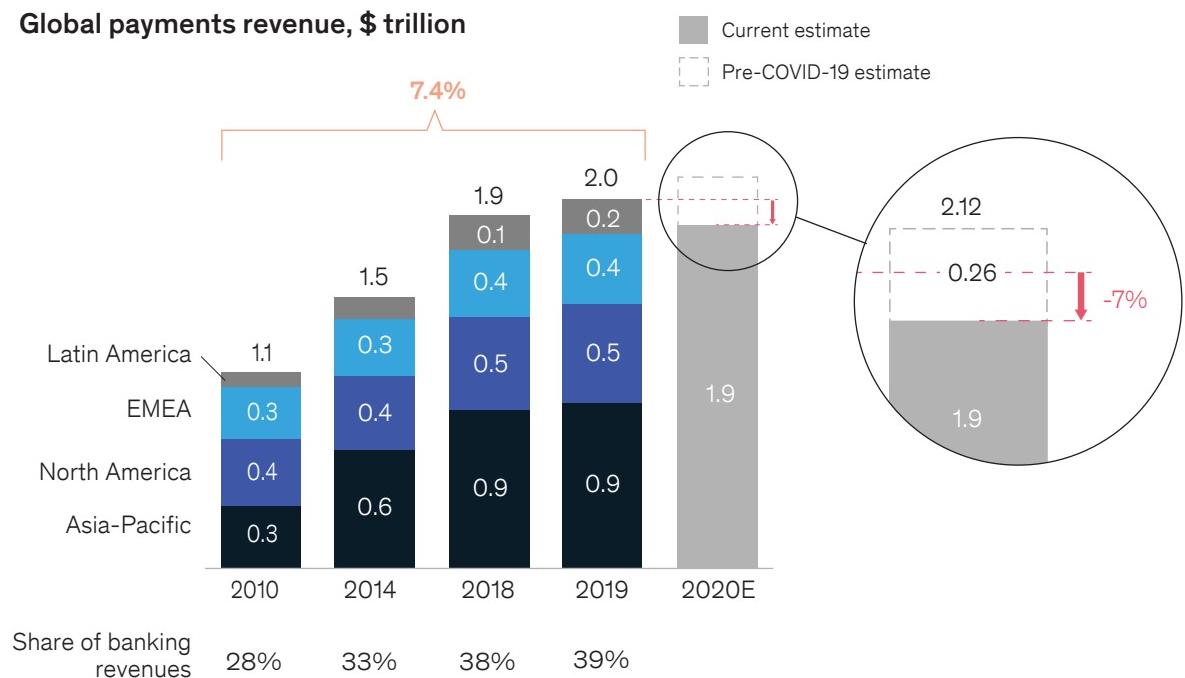
Any stability was quickly disrupted in early 2020 by changing geopolitics coupled with reactions to the COVID-19 pandemic, both public (physical-distancing measures, limits on business activity) and private (anticipatory and causal shifts in consumer and commercial behavior). As a result of the public-health crisis, payments revenues in the first six months of 2020 contracted by an estimated 22 percent (roughly \$220 billion) relative to the first six months of 2019. We expect full-year 2020 global payments revenue to be roughly \$140 billion lower than in 2019—a decline of about 7 percent from 2019—a change equal in size to prior years' annual gains, which leaves revenues 11 to 13 percent below our prepandemic revenue projection for 2020.

What we already know

Once COVID-19 moved from a local outbreak to a global pandemic, many governments moved to protect their citizens, leading to lockdowns with various degrees of limitation. The immediate consequence was, of course, a steep reduction in discretionary spending and a severe demand-side shock, along with reductions in cash usage. Discretionary spending initially sank by 40 percent globally. The impact was especially great on the travel and entertainment category, which was off 80 to 90 percent. While some categories of spending

Exhibit 1

McKinsey expects global payments revenues to end 2020 down 7% compared to 2019.



Note: Figures may not sum to listed totals, because of rounding.
Source: McKinsey Global Payments Map

rebounded, consumers' well-documented shift from the point of sale (POS) to digital commerce accounts for the reduced use of cash.

Overall, in retail, the impact was not a decline but a shift in buying behavior. In the first six months of the year, consumers spent \$347 billion online with US retailers, up 30 percent from the same period in 2019—corresponding to six times the annualized 2019 growth rate of online retail.¹ Amazon's second-quarter 2020 numbers recorded 40 percent year-over-year growth, boosted in particular by the tripling of grocery sales. In Europe, differences in shopping behavior between geographies were strongly reduced and differences between age groups eroded as many consumers (in particular, older shoppers) turned to online shopping for the first time.

Consequently, all forms of electronic peer-to-peer and consumer-to-business payments have been

boosted. In many regions, this has mostly benefited debit cards, which typically align with lower-value transactions and are a logical cash substitute for contact-averse consumers. Switzerland reported an increase in share of debit-card spending from 65 percent to 72 percent between January and May 2020,² mostly at the expense of cash. Higher limits for contactless payments also triggered rising adoption rates across the globe, making inroads beyond debit's typical domain of smaller-value transactions. For credit cards, the picture is more nuanced; consumers in certain geographies seemed to be paying off credit-card balances in preparation for challenging times ahead. In Australia, for example, credit-card share among total card spending fell by five percentage points between February and June 2020, in favor of debit cards.³ In Asia, however, alternative payments, such as instant and mobile payments, grew, while credit cards retained their strong incumbent position supporting

¹ Fareeha Ali, "Charts: How the coronavirus is changing ecommerce," Digital Commerce 360, August 25, 2020, digitalcommerce360.com.

² "Payments and cash withdrawals," Swiss National Bank, data.snb.ch, last modified September 21, 2020.

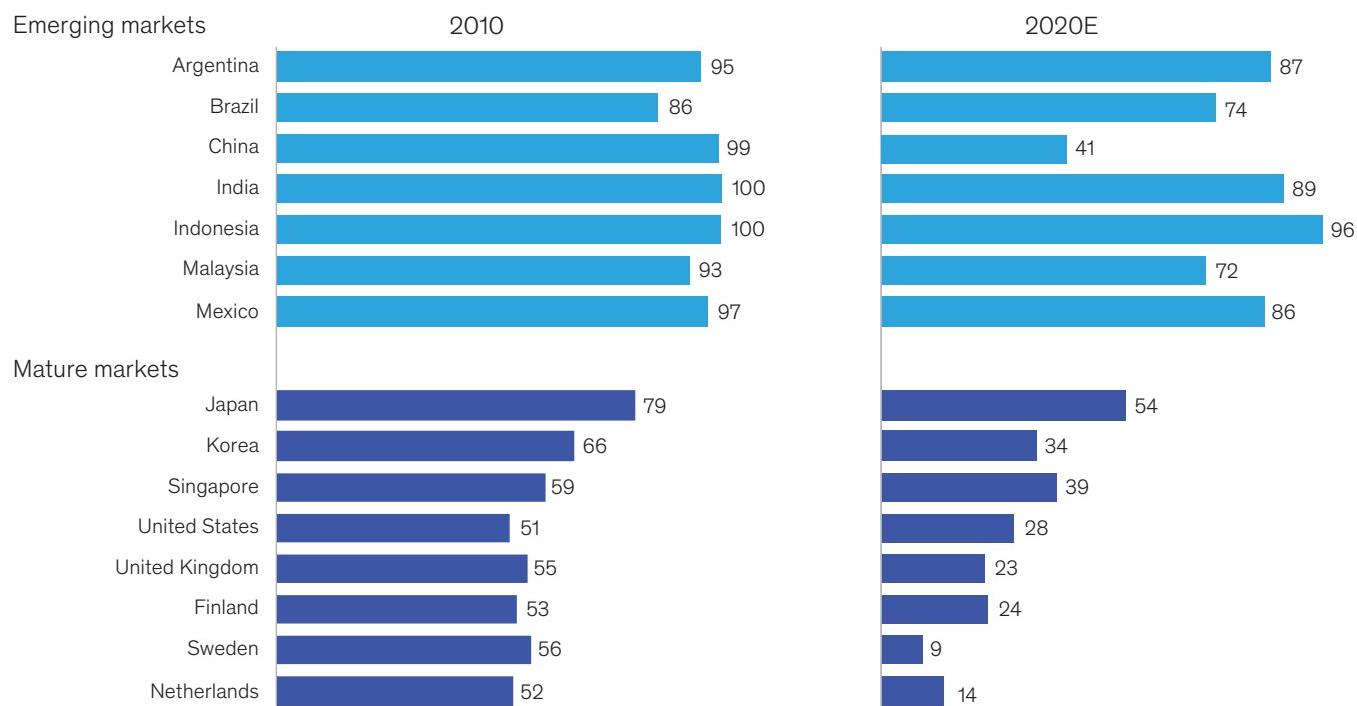
³ Retail payment: May 2020," Reserve Bank of Australia, rba.gov.au, July 7, 2020.

Exhibit 2

COVID-19 will likely lead to a further decline in cash usage.

Cash usage by country

Percent of cash used in total transactions by volume, %



Source: McKinsey Global Payments Map

e-commerce and POS transactions.

Logically, given the steep reduction of in-person purchases, cash transactions and ATM usage declined—the latter after an initial wave of withdrawals by anxious consumers. Germany and the United States each saw spikes in cash withdrawals in the days leading up to lockdowns. The fear of contracting COVID-19 through high-traffic ATMs and, in some cases, the refusal of merchants to accept cash (often despite legal obligations) nudged consumers toward electronic payment options to complete purchases. ATM usage fell by 47 percent in April 2020 in India, while the United Kingdom experienced 46 percent declines per month on average from March to July 2020. By the end of 2020, we expect a shift of four to five percentage points in the share of global payment transactions executed via cash—down from 69

percent in 2019—propelled by evolving behavior in both mature and emerging markets (Exhibit 2). This is equivalent to four to five times the annual decrease in cash usage observed over the last few years. The reduced use of cash benefits banks overall: the cost of cash handling exceeds cash-related revenue inflows, and electronic payments generate incremental revenue.

The pandemic has accelerated the move from “physical” to “virtual” banking. Banks in multiple geographies are closing branches (or in some cases will not reopen branches they closed due to the pandemic), as well as ATMs. In Australia, the top four banks have removed 2,150 ATM terminals and closed 175 bank branches since June.⁴

These accelerated behavior changes in response to the COVID-19 crisis caused a fundamental shift in adoption of technologies, such as real-time

⁴ “Thousands of ATMs in Australia removed, branches closed due to coronavirus,” ATM Marketplace, August 17, 2020, atmmarketplace.com.

account-to-account payment infrastructures, that had been developed over recent years. Investments in instant payments have begun to reap greater benefits, both in POS and e-commerce usage of instant solutions. The trend comes in response to customer expectations for speed, price differences, and greater adoption of customer-facing applications, such as specialists like GrabPay in Singapore or bank solutions like MobilePay in Denmark. In the United Kingdom, as payment speed becomes more important, consumers and businesses have increasingly opted to settle bills online; for example, the average daily value of transactions processed by the Faster Payments service rose by more than 10 percent from the fourth quarter of 2019 to the end of March 2020. In India, banks stepped up their digital propositions, integrating bill payment, e-commerce links, and Unified Payments Interface (UPI)—the nation's local real-time payment system—into mobile banking apps to present three digital options in a single customer interface. UPI spending increased by roughly 70 percent over the first seven months of 2020.

At the same time, governments have tried to protect the economy as a whole and the well-being of companies as well as citizens. Additional easing of monetary policies led to lower interest rates, further deteriorating interest margins. Monetary authorities reduced benchmark rates in Europe and the United States and then in emerging markets, including Brazil, India, and South Africa, to limit the impact of pandemic-related recession, making net-interest-margin (NIM) compression a global phenomenon. Large and small markets alike are experiencing rate cuts of 100 to 300 basis points. Overall, we expect global interest margins to contract on average by approximately one-quarter percent in 2020, compared with a six-basis-point reduction in 2019, shrinking payments revenues globally by approximately \$82 billion. Digitization benefits must first fill this gap before generating growth.

Cross-border payments flows also have been severely affected by the pandemic, as well as by geopolitical dynamics. In 2019, cross-border payments totaled \$130 trillion, generating payments revenues of \$224 billion (up 4 percent from the previous year). In the first half of 2020, many cross-border fundamentals radically changed:

- International travel all but ground to a halt, with more than 90 percent of countries imposing restrictions. Transaction-fee margins on remaining volume also declined, due to waivers offered to stimulate demand to offset the impact of a reduction in leisure and business travel flows, which fell by more than 70 percent.
- During the pandemic, interregional trade saw greater impact than intraregional. Drops in interregional flows for Asia (-13 percent), Europe (-20 percent), and the United States (-23 percent) directly cut into cross-border payments volumes, while the prices of oil and other commodities fell sharply.
- Business-to-consumer payouts (often salary disbursements) and remittance payments slowed, because of restrictions on movement of cross-country workers and growing unemployment.
- Cross-border e-commerce volumes provided a notable exception to the gloomy news: the second quarter brought double-digit growth as initial logistic challenges were resolved. UPS and PayPal, for example, reported double-digit growth on cross-border shipment volumes and value of merchandise sold.
- Increased volatility and uncertainty have enabled growth in foreign-exchange-related revenues and pushed up treasury-related transactions as companies scramble to mobilize surplus cash.

In addition to the health crisis, certain geopolitical forces that began to materialize in 2019 have grown stronger since. Many companies are realizing the strategic weaknesses in their existing global supply chains, given trade frictions and potentially recurring public-health disruptions, leading to the exploration of nearshoring and other rebalancing. McKinsey analysis reveals potential shifts of as much as \$4.6 trillion of global trade flows over the next five years (see chapter 3, “Supply-chain finance: A case of convergent evolution?”, for more). The value-chain shifts that began before the crisis are yet to take full effect—because of the complexity of moving such supply chains and the challenge of building new ones—so this is a longer-term trend.

The rest of 2020 and beyond

The second half of 2020 presents a quite different outlook. Broadly, we see some pressures from the first half continuing but with pronounced

geographic variations.

Our forecast uses McKinsey's nine COVID-19 macroeconomic scenarios.⁵ According to a survey of more than 2,000 executives around the world, the most likely outcome is the "muted recovery" scenario (A1), a combination of virus recurrence and a muted economic recovery, with regional differences.

Applying the A1 scenario to global payments, we forecast that most categories of payment transactions are poised for sharp and rapid rebounds as lockdowns are lifted and behavioral shifts from cash to electronic payments are largely sustained. On the downside, interest-dependent revenue components are likely to remain suppressed for an extended period, mostly affecting banks that provide payment services. For specialists and fee-based revenues, much will depend on differences in spend patterns (for both businesses and consumers) before and after the crisis. For instance, dining, travel, and entertainment expenditures, which often carry higher transaction fees, are unlikely to rebound in the near term.

As we indicated, not all players, countries, and products will arrive at the same end state (see sidebar "A regional overview of the year in payments"). At a regional level, the following differences are notable:

- Asia-Pacific (excluding China) could suffer larger declines, as its revenue model is more affected by NIM contraction, faces increasing government pressures on mass-market transaction fees, and has greater exposure to long-term affected industries, such as travel, tourism, and international remittance payments.
- Europe may be poised for a swifter rebound, for two reasons: First, NIMs were already so compressed before COVID-19 that there was little room for further squeezing; second, volume growth is being fueled by the acceleration of digital migration in Southern and Eastern Europe, and by government stimulus measures.
- In North America, the revenue benefit from an accelerated shift to digital channels has been more than offset by credit-card economics—outstanding balances are down roughly 29 percent from 2019 levels, and increased

delinquencies are a possibility. Considering credit cards are the largest source of the region's payments revenue, at roughly 44 percent, the decline in outstanding balances alone will outweigh the benefits of increased use of digital channels.

- In Latin America, which is characterized by a significant unbanked population, cash usage will likely remain resilient. Among the banked, Visa-supported mobile wallets such as PLIN and Yape have gained more than a million users since December 2019, with the pandemic accelerating this trend.
- Overall, the greatest recovery opportunities reside in countries with low electronic penetration (Brazil, India, Indonesia, Thailand), as the next normal provides impetus for electrification. However, countries starting from a high level of digitization (France, Germany, the United Kingdom) are also seeing COVID-19-induced behavior push cash usage to the minimum—fueling payments-revenue growth.

Overall, while the global health crisis leaves banks and specialists with meaningful revenue concerns, the real challenge—as well as the real opportunity—lies in embracing the acceleration of change. If that issue is addressed properly, the global impact on payments could be significantly more positive than the outlook for GDP (see sidebar "The relationship between GDP and payments revenue").

Looking forward: New rules for engagement

Long-term forecasting is unusually difficult in the current global environment, given the looming uncertainty on multiple fronts: economic recovery, interest rates, global trade, and a murky time frame for public-health breakthroughs. One thing seems clear, however. The imperative to accelerate transformations to a digital-first and more agile organization has never been greater, and it exists globally.

Still, the current global context removes many of the long-standing impediments to embracing transformation. As financial institutions enter this period of change, we propose five major themes to which payments and bank executives should be particularly attentive:

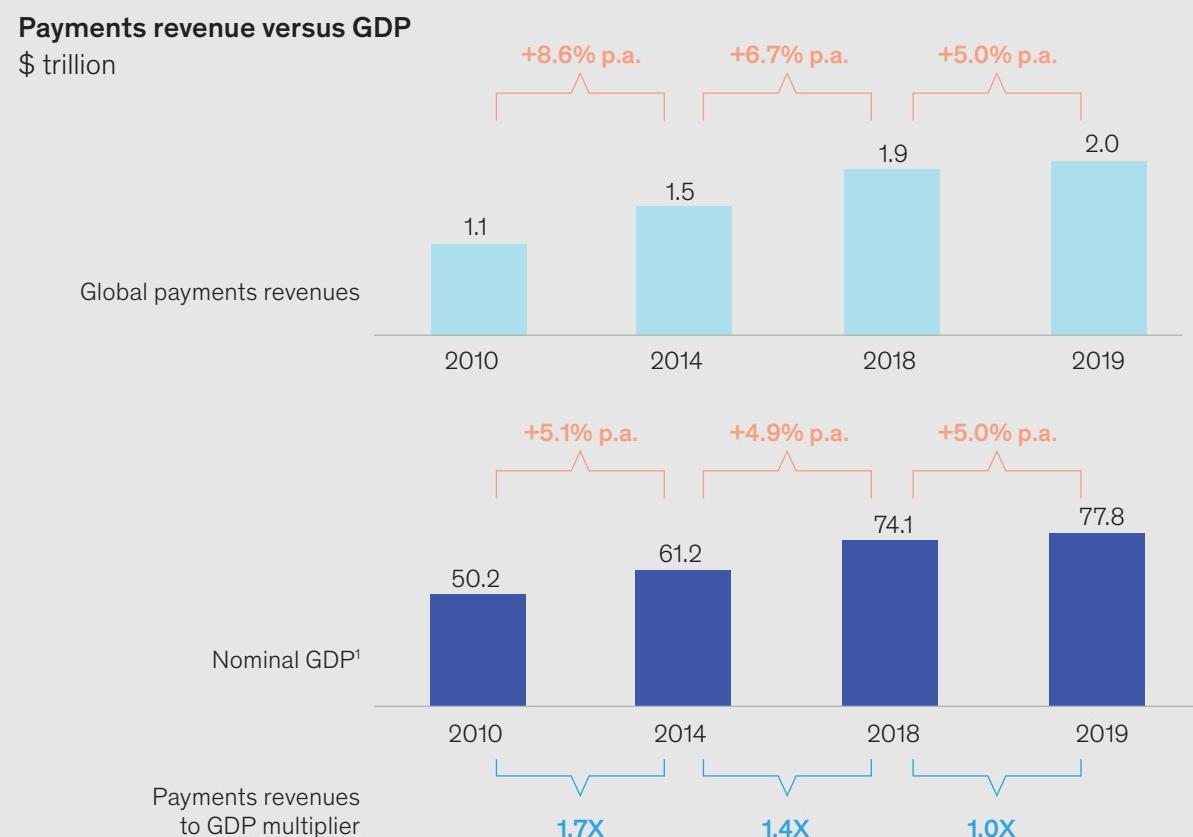
⁵ Sven Smit, Martin Hirt, Kevin Buehler, Susan Lund, Ezra Greenberg, and Arvind Govindarajan, "In the tunnel: Executive expectations about the shape of the coronavirus crisis," April 2020, McKinsey.com.

The relationship between GDP and payments revenue

Over the last decade, payments revenues have grown substantially faster than GDP (Exhibit A). Between 2010 and 2019, nominal GDP has grown at roughly 5.0 percent in the geographies covered by the Global Payments Map, while payments revenues have grown at 7.4 percent, or 1.5 times the GDP growth rate. This multiple has, however, been decreasing, largely as a result of an increasingly global contraction of net interest margins (NIMs), as well as ongoing regulatory pressures, which mostly affected card fees. In 2019, payments revenues grew at 5.0 percent, roughly 1.01 times GDP growth, mainly resulting from contraction in NIMs.

Exhibit A

Growth in payments revenues has outpaced GDP growth.



¹ For countries covered by Global Payments Map
Source: McKinsey Global Payments Map

- *Choose where you play wisely.* The composition of your customer portfolio matters more than ever, as restructuring of consumer and commercial commerce reshapes where value is captured in payments. Growth is notably accelerating in the small and medium-size enterprise (SME) segment, B2B-to consumer (B2B2C) business models, and new customer arenas, such as cross-border e-commerce. The role of platforms also is growing fast, with

ecosystems a new growth segment. The shift to digital makes it possible for providers to create far more tailored solutions, and customers have shown a willingness to pay for these if sellers demonstrate value.

- *Services and solutions, not financial products.* Commercial customers expect bank and payments partners to enable greater sales by improving end-customer experience and the adoption of new business models—for

A regional overview of the year in payments

The relative contributions to global revenues of all four geographic regions remained consistent in 2019. Each region posted solid mid-single-digit growth in payments, led by Latin America at 6 percent. Asia-Pacific continued to lead both in growth and in its contribution to global revenue—45 percent of the total, with China generating the lion's share (Exhibit A). The rate of Asia-Pacific payments growth continued to moderate from its double-digit rates of a few years ago, given margin compression on current-account balances across the region and China's GDP expansion receding to a more sustainable rate.

At slightly over a quarter of the overall pool, North America remains the second-largest contributor to global revenues and grew at par with global trends. Growth in Eastern Europe, the Middle East, and Africa (EMEA) slightly exceeded the global average, mainly due to acceleration in the emerging markets of Eastern Europe and Africa (10 percent growth in revenues). Western Europe grew at just 1 percent, although it had already largely absorbed the effects of interest-margin compression that had affected the region in earlier years.

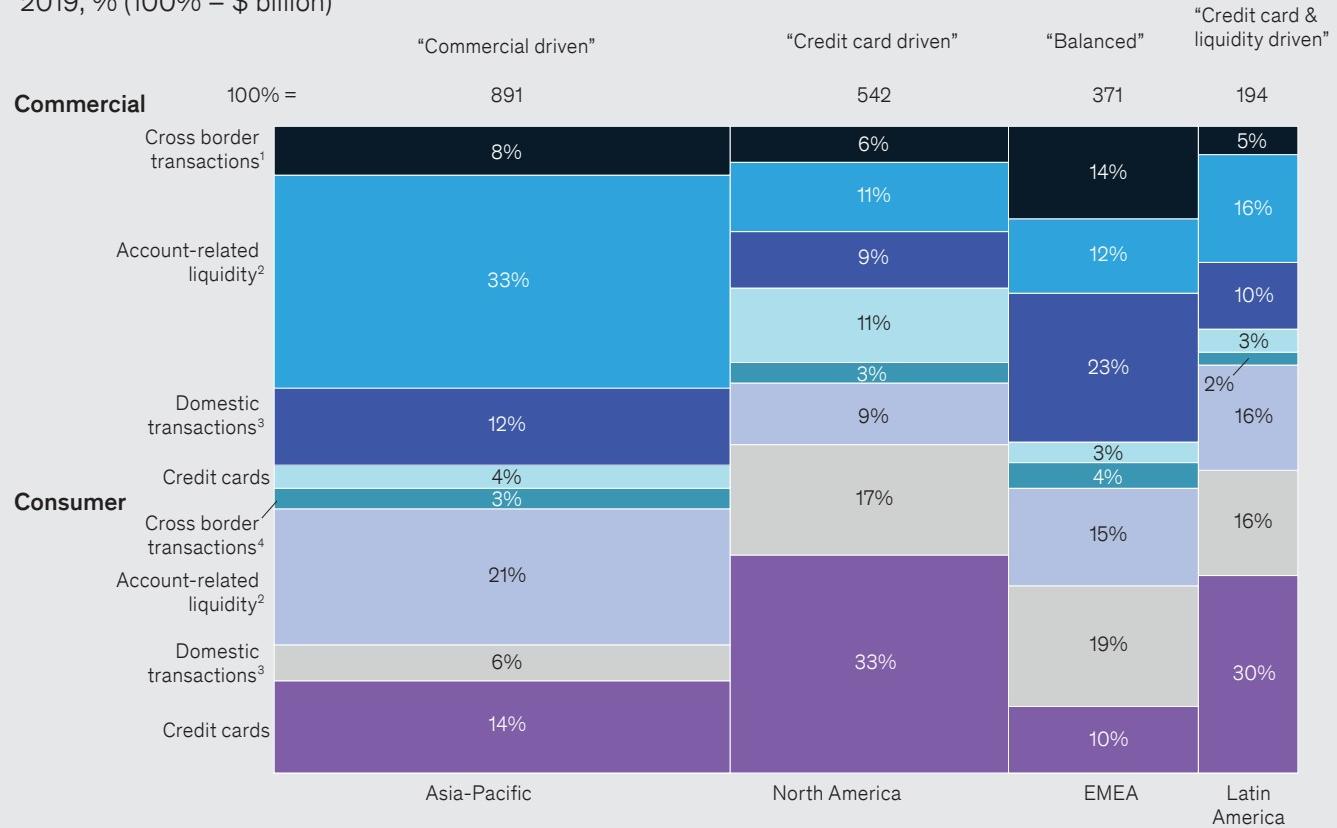
Globally, the number of electronic-payment transactions continued to grow at healthy rates in 2019, just shy of 20 percent annually (at 10 percent in terms of value conveyed). Disproportionately high contributions came from China (56 percent

Exhibit A

Asia-Pacific continued to dominate the global payments revenue pool.

Payments revenue,

2019, % (100% = \$ billion)



¹ Cross-border payment services (B2B, B2C).

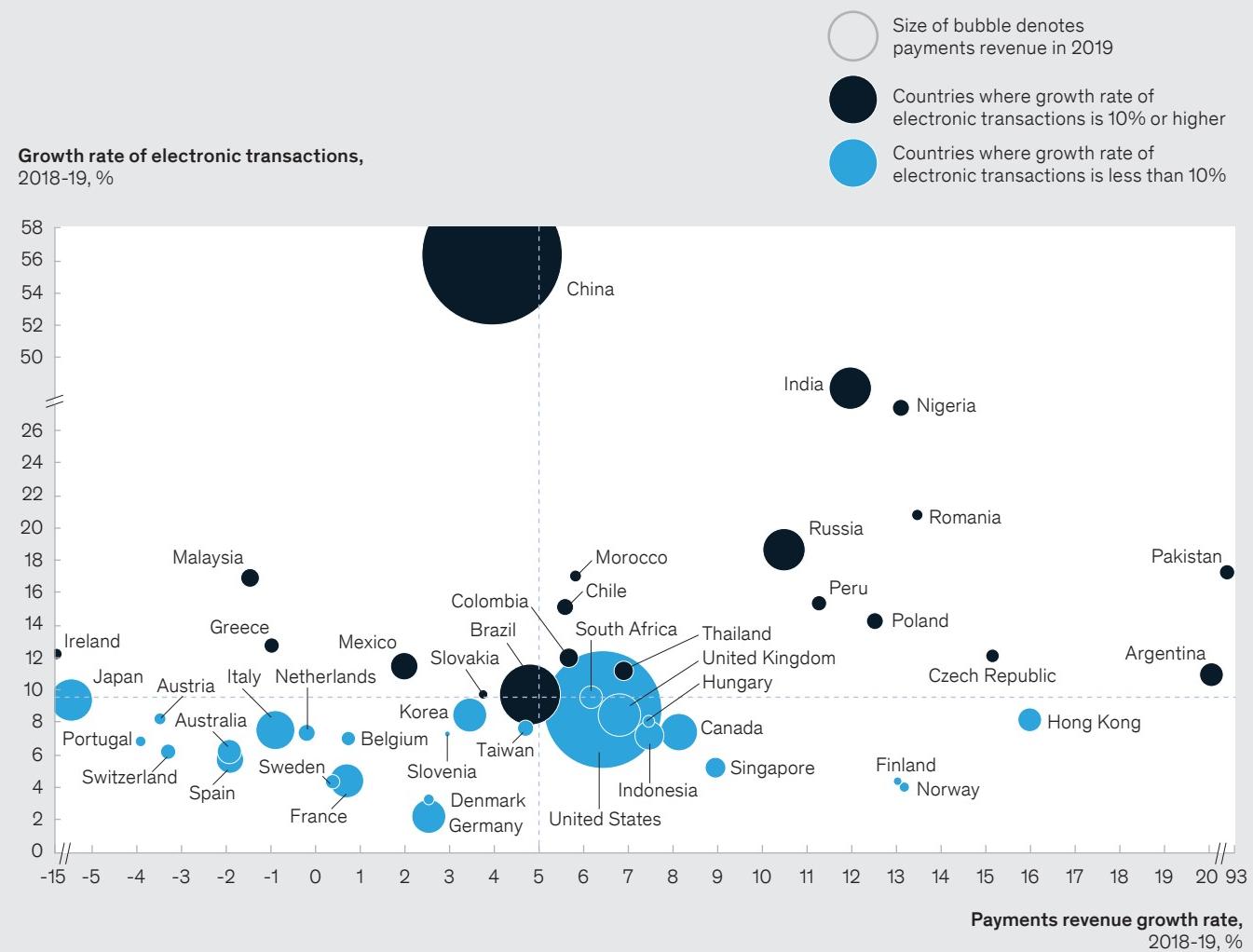
² Net interest income on current accounts and overdrafts.

growth), India (48 percent), and Russia (19 percent). Despite a reduction in fee margins per transaction globally (from an average of \$0.97 to \$0.89 per transaction for electronic payments), these additional volumes propelled overall fee-based revenues from electronic payments to new highs (a 9.75 percent increase in fee income for all products except cash and checks).

Alternative payment methods (APMs), such as e-wallets and instant-payment-based solutions, continue to play a key role in accelerating cash substitution, particularly in developing countries. APMs have particularly gained traction in China, where they generated about \$43 billion in 2019 revenues, far exceeding the approximately \$22 billion for the rest of the world collectively (Exhibit B).

Exhibit B

Countries with high revenue growth are also characterized by rapid electronic transaction growth.



Source: McKinsey Global Payments Map

instance, marketplace onboarding, B2B2C credit, and loyalty services—that do more than move money and manage cash flow. For consumers, the payment step is moving into the background of the shopping journey, and they expect support with conducting commerce and avoiding negative consequences, not merely a means to pay.

- *Sales excellence.* Transaction banking and acquiring are nearly a decade behind the technology and telecom sectors in sales and customer-management practices. These other industries have an entirely different skill set and language for sales and service: sales motions, agile sales, inside sales, customer success—all made possible by data and algorithms delivering the best adapted solutions for the market. Closing this decade-wide gap over the next two years will deliver significant value.
- *Transaction-banking client experience.* New challenges in supply chains and growing trade pressures are accelerating what has been a slow disruption in international payments and trade. Delivering the long-promised step-change improvement to corporate clients will require fundamental organizational change, particularly for siloed banks.
- *Changing the focus from “time value of money” to “money value of time.”* Becoming digital by default requires significantly redefining the institution’s operations through the lens of customer journeys. To plan that digital transformation, most players have built road

maps spanning the next five to six years. But given the modified revenue context, continued investment requirements, and market expectations spurred by the new environment, winners will find a way to deliver on this transformation within 18 to 24 months. In chapter 4 of this report, we explore the various models that such a payments modernization could leverage.

The events and trends of 2020 have undeniably created a changed global context for payments. What is most significant about this change is not so much the importance of the payments business or the kinds of trends transforming the market, but the speed at which the change is occurring. Change in 2020 takes place four or five times faster than before. This puts all actors on the payments landscape under pressure to transform and adapt in order to preserve their positions and results.

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The authors would like to thank Vaibhav Dayal and Baanee Luthra for their contributions to this chapter.

Merchant acquiring: The rise of merchant services

The shift to electronic transactions has placed front and center the need for merchant acquiring companies to update and differentiate their service offerings.

Puneet Dikshit

Tobias Lundberg

Globally, merchant acquiring has evolved over the past decade from a legacy processing and hardware business to a full-stack software and merchant-services solution. This shift, coupled with the fragmentation of the merchant-facing payments value chain, is dramatically affecting the economics and business models of merchant acquisition as it was done in the past, favoring instead the value-added approach of the new merchant-services players.

The evolution of merchant services typically involves a pattern in which revenues from merchant processing are being commoditized, and in response, players seek to differentiate, either by expanding their product suite or by building scale—mostly through acquisitions—across geographies, distribution (e.g., integrated software vendors, bank led), and delivery channels (e.g., digital, point of sale). Although the trends and trajectory are similar across regions, certain geographies are further ahead. As acquirers shape their priorities for the next decade, the transformations spurred by 2020's public-health crisis will play a big part in the way they rethink their vertical focus, platform strategy, and investment priorities.

New winners and complex needs compel a reevaluation of focus and value propositions

As detailed in Chapter 1, one of the COVID-19 pandemic's most visible impacts on financial services has been the dramatic acceleration in shifts toward e-commerce and digital payments. This is true not only in more mainstream verticals, such as fashion and groceries, but also in merchant segments like healthcare, professional services, and education,

which historically have not received a material portion of payments through B2C digital channels.

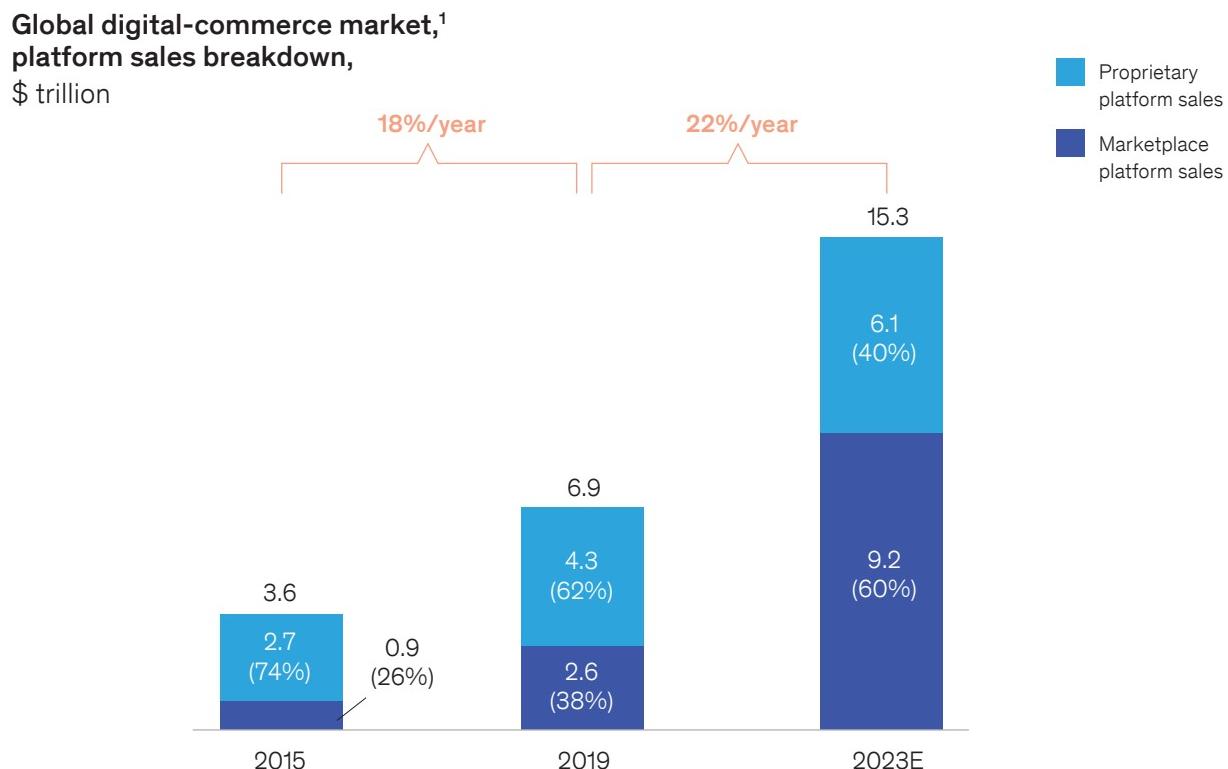
This has led to an unprecedented digitization of small-business commerce across geographies, mostly through marketplace platforms. Marketplace Platforms like Amazon, eBay, Etsy, Flipkart, and Shopify have seen seller sign-ups increase by 70 to 150 percent since the start of the pandemic, based on their most recent filings and public statements (Exhibit 1), while proprietary platforms are losing share. In healthcare, there has been a surge in provider participation for services like telemedicine, which in turn is highlighting a growing need for B2C digital payments in professional services, education, and other areas.

This shift to digital is driving up merchants' payments-acceptance costs, which are expected to rise by an incremental \$8 billion to \$15 billion (about 6 to 10 percent) as commerce migrates to these higher-cost channels. Just as importantly, merchants also face higher decline and fraud rates on digital transactions, with ramifications for customer experience.

As these at-scale marketplaces and platforms consolidate their share of digital sales, they naturally seek to lower their cost of acceptance, which in turn adversely impacts margins for acquirers. At the same time, however, digitization of commerce has created greater willingness to pay for enhanced services and solutions. Merchants are willing to accept higher fees for demonstrated value, such as improved authorization rates, a more seamless payments experience, or improved cart conversion through point-of-sale financing. Even in sectors like grocery, where acquirer margins have approached

Exhibit 1

Digital marketplaces are expected to account for about 60 percent of digital-commerce volume in the next few years.



¹ Includes retail; travel, media, and entertainment; food and beverages; bill payments; and others.
Source: McKinsey Global Payments Map; McKinsey Digital Commerce Benchmark

structural floors over the past few years, merchants are willing to pay 20 to 30 percent higher rates for better payments performance, particularly when the impact on the business is positive and significant. Higher-margin verticals, such as fashion and accessories, are seeing increased demand for financing solutions and affiliate marketing products. As an example, within the fashion and accessories verticals in the United States, the number of merchants signed up for buy-now, pay-later solutions has nearly tripled.

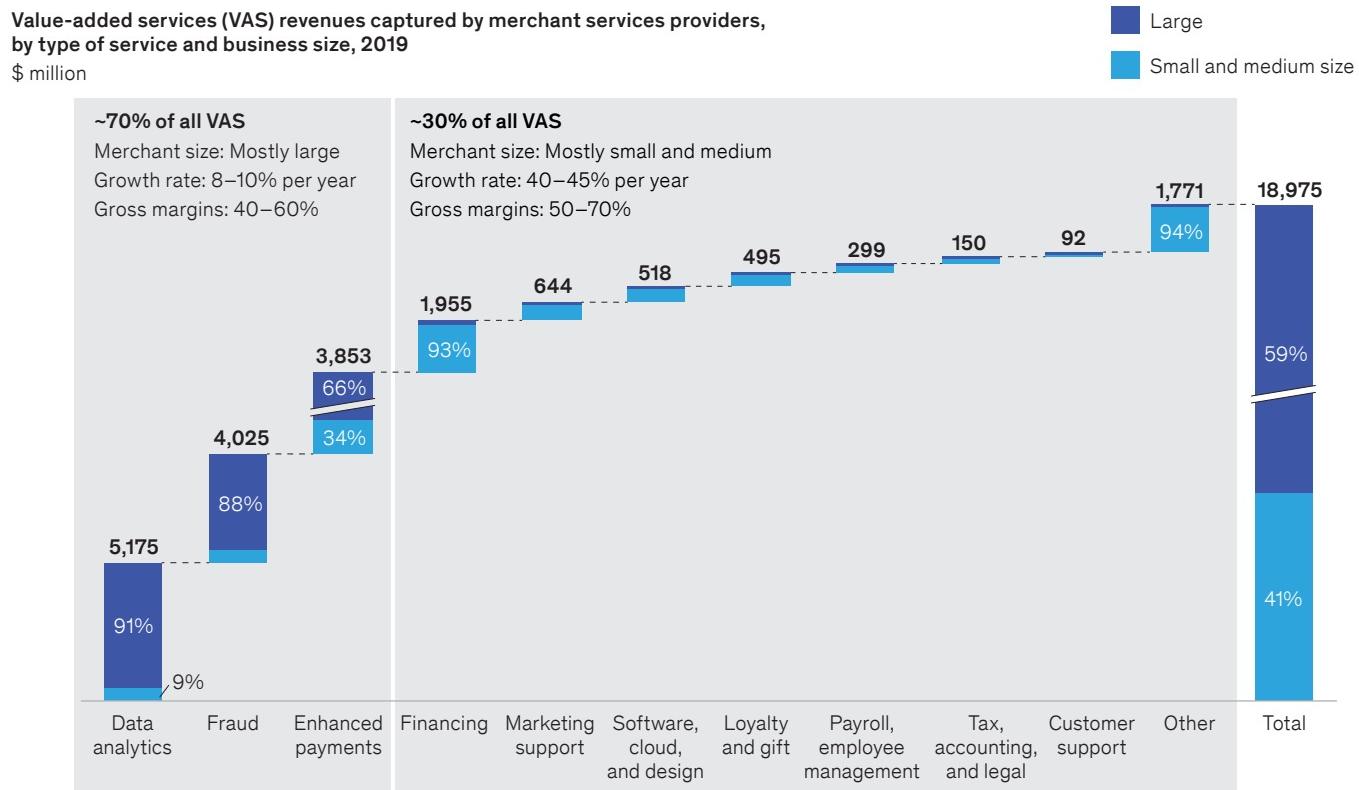
Leading acquirers are starting to transform in two distinct directions: adding targeted value propositions and becoming marketplaces themselves. Industry-focused value propositions address market needs for service and risk levels, fees, value-added features, partnerships, and back-end integration. This approach is not necessarily industry specific; acquirers are increasingly segmenting industries into groups based on specific needs, such as a pay-later segment, delivery segment, prebook segment, and repeat-

visit segment. Just as importantly, acquirers themselves are beginning to resemble marketplaces by offering solutions like payments disbursement, financing and onboarding for small and medium-size enterprises (SMEs), commerce marketplace know-your-customer services, sub-merchant account creation and management, and SME-facing risk and identity solutions.

Most large acquirers have invested heavily in core payment-enablement services like authentication, fraud, and alternative-payment-method (APM) acceptance and in creating omnichannel acceptance and settlement, but relatively few have capitalized on the opportunity to deliver enhanced value-added services to large retailers (Exhibit 2). Given the growing willingness of large retailers to pay for such services and to seek these from their current providers, this is a significant opportunity for current portfolio monetization and margin protection. The focus of these investments in add-on services will be influenced by the vertical focus of each merchant-services provider.

Exhibit 2

Small and medium-size enterprises are contributing to a growing share of value-added services in payments revenue.



Source: McKinsey Payments Practice

Acquisitions have helped build geographic and capability scale, but not solution scale

The consolidation in merchant acquiring over the past several years has enabled acquirers to build scale across geographies and to enhance their suite of capabilities to stay competitive in the face of next-generation merchant-services platforms, including Adyen, Checkout.com, and Stripe.

However, this spate of acquisitions has also led to acquirers being laden with numerous regional, duplicative, and subscale solutions, adding to technology overhead. Over time, this will impede efficiency and interfere with acquirers' ability to serve multi-geography merchants, especially in digital segments. Some of the largest acquirers are saddled with 12 to 15 different regional gateways or platforms that leave them, unlike next-generation acquirers, ill-equipped to offer their clients an

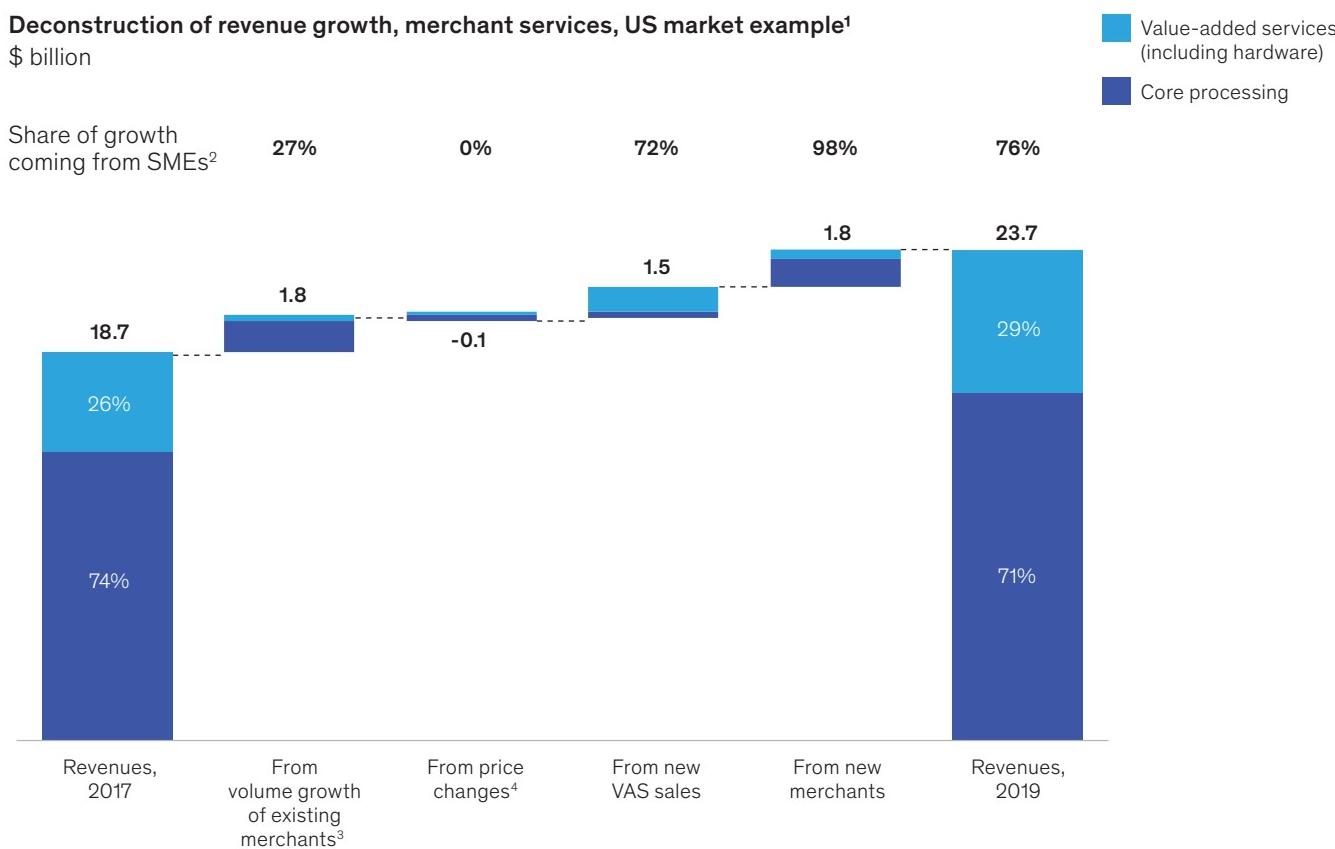
at-scale, multi-geography solution.

Although continued consolidation is likely, an increasingly important tactic is for acquirers to invest in building a set of scalable solutions fit for purpose for priority merchant segments. As margins on traditional payments services continue to be compressed, solution scalability will become increasingly critical to sustain the business's economic viability.

In addition to the scalability of solutions, significant untapped opportunity lies in enhancing the scalability and sophistication of data infrastructure to enable targeted use cases around enhanced authorization, fraud, and performance-based payments arrangements. For example, payments-services providers are offering performance-based arrangements that include authorization warranties, which are fee constructs linked to fraud reduction based on advanced analytics.

Exhibit 3

Most revenue growth in merchant services is from small and medium-size enterprises.



¹ Total excludes network assessment fees.

² Small and medium-size enterprises, classified as businesses with <\$100 million in revenues or sales where the cost of payments acceptance is directly borne by the SME; excludes marketplace-like models that do not directly pass on acceptance costs.

³ Growth from underlying growth in sales; value-added service revenues attributed to services linked to processing a transaction but sold separately (eg, enhanced authorization).

⁴ Growth linked to price changes. Recent pricing pressure has led to price declines.

Source: McKinsey Payments Practice

The acceleration of SME digitization has further underscored the value in the long tail

Even prior to COVID-19, most of merchant-services providers' revenue growth came from the long tail of SME customers. Most acquirers have targeted this opportunity through indirect distribution channels (e.g., integrated software vendors and web-store providers), as scaling through direct channels poses a more complex challenge. In markets with bank-owned acquirers, this transition to indirect channels has been slower, given the ability of bank-owned acquirers to sell directly within their own base.

Regardless of the channel, however, SMEs have accounted for about three-quarters of all new revenue growth in the merchant-services space over the past three years, especially in established

markets (Exhibit 3). Serving SMBs requires hyperregional strategies for distribution and scale.

In mature markets, acquirers are increasingly focusing on distribution through ISOs (independent sales organizations), ISVs (integrated software vendors), and other indirect channels, relinquishing 40 to 80 percent of revenue margins as residuals to their channel partners. As COVID-19 has accelerated a flight to digital for SMEs across verticals, some of banks' ISV-led models have been taken a financial hit. Within the restaurant space, for example, at-scale food-delivery apps like Just Eats, Uber Eats, and Zomato have gained scale, and transaction volume has shifted from the in-store ISV to the food-delivery applications, meaning those transactions are no longer processed by the restaurant's acquirer or processor. Under those conditions, acquirers need to rethink their

approach to partnerships and develop models that deliver more value to merchants through their ISV partners—for instance, merchant cash advances, point-of-sale financing solutions, analytics, and omnichannel reconciliation.

In emerging markets, ISVs are steadily gaining share, but most of the sales still leverage traditional agent-based or direct models. Bank-owned acquirers have an advantage in many of these markets but often lag in sales and product sophistication. In these markets, acquirers still have the opportunity to invest in building a point-of-sale platform-based business that enables them to serve a broad swathe of merchant needs and monetize the SME relationship in a more holistic fashion.

Trade barriers and government intervention hinder market expansion and enable local wins

The economic slowdown has increased many governments' willingness to accept additional investment avenues, somewhat counterbalancing the impact of recent trade disputes. The competing priorities of regional governments are likely to interfere with companies' ability to enter into new markets organically. Acquirers will need to consider regional sponsorships, acquisitions, or joint ventures to enter priority markets.

This "slow-balization" is also expected to fuel the growth of regional supply chains. This will create a need for regionally integrated solutions, especially in B2B payments. Acquirers that have been slower to pursue the value pools in B2B digital commerce, due to its multi-geography complexities, may now be able to pursue opportunities at a regional level.

Preparing for 2021 and beyond

As acquirers and merchant-services players reorient to prepare for the next decade, several key areas require focus:

- *Investing to transform into a platform business for larger merchants.* Most large merchants are grappling with the accelerated shift to e-commerce, which has created more pronounced payments digitization needs at the point of sale, including contactless payments, enhanced authorization, fraud and chargeback mitigation solutions, financing at point of sale, sub-merchant onboarding, and payments remittances. Acquirers have a unique opportunity to shift from being a traditional

payments acquirer or processor and bring together proprietary and partner solutions into a single platform for larger merchants, which also enables bundled economics and better value creation.

- *Investing in SME channels in emerging geographies to capture share.* The shift toward ISV-led models across markets is imminent; acquirers need to assess their strategic posture to address this trend. The build-out and scaling of direct-to-SME models will be capital intensive but potentially more lucrative if acquirers can create SME-focused one-stop-shop platforms. Investing in these channels and value propositions over the next 18 to 36 months, before these markets tilt toward ISV-led models, will position them to compete much more effectively.
- *"De-cluttering" infrastructure.* The spate of acquisitions has led to often redundant data and software platforms that are burdening at-scale merchant acquirers, hindering their ability to compete with next-generation players that have built more integrated, scalable solutions. There is a dramatic need for rationalization of software, data platforms, infrastructure, etc. to enable acquirers to support merchants efficiently across geographies, verticals, and devices.
- *Aligning and simplifying organizations to mirror emerging and at-scale merchant profit pools and needs.* Segmenting customers into enterprise (and within this marketplace models, pure-play subscription, travel, at-scale retail) and SMEs (and within this direct, bank-led, ISO/ISV/VAR led, partner-led) and organizing the business around segments based on how customers buy is critical to compete effectively. Such alignment will enable acquirers to invest appropriately in sales effectiveness and commercial enablement, thereby improving go-to-market and pricing approaches as well as progress tracking.
- *Directing investments to digital ISVs and payments-adjacent offerings.* With traditional processing revenues under sustained pressure, acquirers should focus investment on scaling integrations with digital ISVs and creating payments-adjacent offerings where they have a value-added play (e.g., POS financing, rewards redemption at point of sale, SME financing). Acquirers should better monetize their role within the value chain as an enabler between

- issuers/service providers and merchants, e.g., explore the material opportunity to act like a marketplace or and “app-store.”
 - *Differentiating through data.* Differentiate solutions on data and monetize data more effectively to enable enhanced authentication, fraud, and chargeback use cases. The shift to digital has created a much greater demand for enhanced authorization, real-time data connectivity, better data-enabled fraud, sub-merchant underwriting decisions etc. Acquirers possess a gold mine of data but the complexity of disparate platforms, unclear data strategy, poor data architecture, and limited build-out capabilities have impaired the ability to effectively monetize this asset.
 - *Avoiding complacency on alternative payment methods.* The growth of APMs, fueled by evolving regulation, ongoing innovation and retailer interest, will necessitate their inclusion in acquirer portfolios. APM strategies must evolve to a point where acquirers have a clear view on when and how to directly integrate vs. license through APM aggregators or other consolidators. In addition, as APMs capture a growing share of transactions, acquirers will need to refine pricing/revenue/fraud models to drive value.
 - *Rationalizing customer processes.* As the number of devices, interfaces, payment means, and channels continues to increase, acquirers are in a privileged position to aggregate, triage, and monetize a “guaranteed best route” experience. A customer journey-based view of payments evolution is critical to its enablement.
-

The merchant acquiring industry will likely see continued consolidation on the acquiring side and sustained fragmentation on the distribution side. Growing commoditization of processing will need to be offset by improved sophistication of solutions and enhanced back-end efficiencies. Competing effectively will require scale not just across geographies and verticals but across solutions as well. As merchants across sectors rethink their acceptance and payments needs and journeys post-COVID-19, the acquirers who orient themselves to innovate around these needs and journeys are best positioned to win.

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The authors would like to acknowledge the contributions of Diana Goldshtain and Tamas Nagy to this chapter.

Supply-chain finance: A case of convergent evolution?

The complexity of the supply-chain finance industry poses difficulties in a time of economic turmoil, but innovative players have opportunities to seize.

Alessio Botta

Significant value in the global supply-chain finance (SCF) market remains untapped. Nearly 80 percent of eligible assets do not benefit from better working-capital financing, and the remaining one-fifth of assets are often inefficiently financed. Despite improvements made in recent years, advances have been largely incremental.

Reinhard Höll

We now see change accelerating in the market in response to a convergence of factors: an increased focus on working capital, structural changes in financing for small and medium-size enterprises (SMEs), a step change in digital adoption, and the potential geographic relocation of \$2.9 trillion to \$4.6 trillion in spending on cross-border supply chains (for 16 to 26 percent of global goods exports) over the next five years. Could these events spur the long-anticipated transformation of the landscape?

Reema Jain

The answer may be yes. In this chapter, we outline key drivers and how they could lead to real change in access to and availability of SCF. We then offer a vision of what such a transformation could look like and what it would mean for market participants.

Nikki Shah

Supply-chain finance: An age-old need

Supply-chain finance may well be one of the earliest commercial-payments activities. It has enabled every major trade and supply-chain flow through time, from trade exchange in early Mesopotamia to receivables credit in the 1800s Industrial Revolution, to letters of credit and even blockchain for global supply chains today (see sidebar “What is supply-chain finance?”).

Lit Hau Tan

The industry fulfills banking’s basic promise of financing the working capital necessary to run any business. When successfully delivered, supply-chain finance benefits the entire ecosystem: it enables corporate buyers to secure inventory by extending payments terms, and it improves certainty on forward orders for suppliers. Banks and nonbank SCF providers generate stable, short-duration (and hence lower-risk), often recurring transaction volumes while creating an avenue for broader offerings such as foreign exchange, cash management, and capital-markets products.

SCF has only partially delivered on this promise, however. Often it is focused on larger, well-financed multinational corporations and their supply chains, whereas smaller and less well-financed enterprises face barriers to access. Many catalysts—including digital delivery, fintech innovation, industry utilities, blockchain, and API technologies—could stimulate cheaper and more accessible SCF, but change has been slow. Now in 2020, the impact of COVID-19 has contributed to accelerating digital adoption and reconfiguration of trade and supply chains—for example, to improve resilience and diversify sourcing.¹

A promise made but not (yet) kept

While supply-chain finance fulfills an age-old need, its potential continues to be limited by its complexity. We can measure this complexity along four major axes: fragmentation of delivery, fragmentation of the underlying assets, limited credit and expertise, and geopolitical turmoil.

¹ See “Risk, resilience, and rebalancing in global value chains,” McKinsey Global Institute, August 2020, on McKinsey.com.

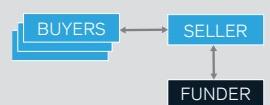
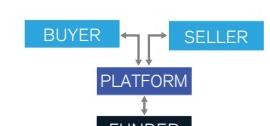
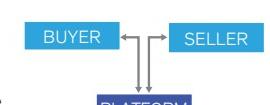
What is supply-chain finance?

The overall trade finance market can be roughly differentiated into three segments, each with unique product dynamics (Exhibit A):

- **Documentary business** includes traditional off-balance-sheet trade finance instruments, such as letters of credit, international guarantees, and banks' payments obligations. These instruments are typically used to cover the two corporate parties against potential transaction risks (e.g., an exporter protecting against country-related risks of its importer's domestic market).
- **Seller-side finance** includes two main financial instruments: factoring and invoice finance.² These instruments address the financing needs of corporate sellers by anticipating liquidity related to commercial transactions.
- **Buyer-led SCF** (referred to as supply-chain finance throughout this article) is typically aimed at large buyers and their suppliers. It covers the financing needs of suppliers originated by large buyers, like reverse factoring, where suppliers can access third-party financing for buyer-approved invoices, as well as dynamic discounting, where buyers pay suppliers early in exchange for discounts on the invoice. This has traditionally been a smaller and more fragmented market (roughly \$500 billion of turnover financed), but is now growing at double-digits, driven by increasing interest and new offerings by players

Exhibit A

Buyer-led solutions are the fastest-growing part of the \$7 trillion trade and supply-chain finance landscape.

	Value of assets financed, \$ trillion	Expected CAGR, 2019-24	Description	Model
Total trade and SCF turnover	7.3			
Documentary business	3.8	1-2%	Seller provides all transaction-related shipping documents to their bank, which works with the buyer's bank to process the payment	
Seller-side finance	3.0	3-5%	Seller provides all information linked to receivables financing; suppliers typically sell/borrow against full accounts receivable	
Buyer-led SCF				
Reverse factoring	0.4	15-20%	Platforms facilitate financing on the basis of buyer-approved invoices Platforms can be supplied by individual banks, fintechs, and other industry players (eg, consortia)	
Dynamic discounting	0.1	25-30%	Platforms facilitate modified payments terms (invoice discounts) between buyers and suppliers directly No funding involvement – “platforms” are typically supplied by fintechs	

Source: McKinsey Global Transaction Banking service line

² Some market participants also include variations of invoice finance, including receivables finance, pre-shipping finance, and even commercial overdrafts and commodities finance.

Fragmentation of delivery

While SCF providers are increasing in scale and product range, delivery tends to be fragmented. A fully digital, seamless experience is held back by several remaining barriers:

- *Manual and fragmented process flows.* There are technology solutions that can streamline the financing process, e.g., by allowing automated data flow via integration with enterprise-resource-planning (ERP) and procurement systems and with core systems. However, many corporates shy away from fully digitizing procure-to-pay and invoicing processes. For example, ERP integration of a single SCF system usually takes two to four months or more and requires upfront investment and resources, which increases the difficulty of justifying automation and speeding up supply-chain financing triggers.
- *Fragmented data sharing.* Companies continue to work on developing data-sharing utilities such as standard application programming interfaces (APIs) and arm's-length data repositories. But these solutions have not yet demonstrated sufficient ease of use and earned the confidence customers seek before they will share ERP and invoice data at scale. As a result, SCF providers must bear the costs and delays of cleansing and shaping invoice data before making onboarding and financing decisions.
- *Slow onboarding and credit decisions.* SCF processes still involve long cycle times and uncertain time to decisions. As payments expectations move to real time, SCF will need to accelerate the typical multiday cycles that inhibit corporates from accessing working-capital relief.

Fragmentation of underlying assets

Along with delivery, underlying assets tend to be fragmented. Payables and receivables vary widely in terms, duration, and underlying creditworthiness. Much of SCF has focused on higher-rated, larger corporates and recurring, high-value invoices, especially given the higher costs attributable to fragmented delivery. Often, less than half of total spend is eligible for financing, with uptake at about 60 to 70 percent of eligible

volumes. Furthermore, small and medium-size corporates, as well as one-off, more variable invoices, struggle to access SCF.

Limited credit provision and SCF expertise

With a limited secondary market, provision of supply-chain financing is restricted by the number of individual banks and nonbank providers with sufficient risk appetite and know-how. Many institutions cannot offer the full range of SCF assets, because they have limits on exposure or risk and limited expertise in underwriting and because they lack existing processes. As a result, large segments of corporates—for example, those where most SMEs are customers of small banks—have no access to SCF.

Fundamental shifts in global trade

Global trade volume grew by 6 percent (CAGR) between 1990 and 2007. From 2011 to 2018, the trade volume grew at a 3 percent CAGR, pushing the absolute trade volume to new heights, according to the World Bank. According to McKinsey's latest report³ on global trade and value chains, in 2017, total global trade stood at \$22 trillion, with trade in goods at \$17 trillion. Trade in services, though smaller at \$5 trillion, has outpaced growth in goods trade by more than 60 percent over the past decade (CAGR of 3.9 percent).

We believe there are three fundamental forces that will affect global value chains in the near future:

- As domestic consumption grows in countries like China, global demand—which historically has tilted toward advanced economies, is shifting to a greater focus on developing nations. Emerging markets are expected to consume almost two-thirds of the world's manufactured goods by 2025, with products such as cars, building products, and machinery leading the way. By 2030, developing countries are projected to account for more than half of all global consumption.
- Developing economies are building comprehensive domestic supply chains, reducing their reliance on imported intermediate inputs and thereby reducing cross-border trade flows.
- Global value chains are being reshaped by cross-border data flows and new technologies,

³ Susan Lund, James Manyika, Jonathan Woetzel, Jacques Bughin, Mekala Krishnan, Jeongmin Seong, and Mac Muir, "Globalization in transition: The future of trade and value chains," January 2019, McKinsey.com.

Supply-chain leaders will focus on resilience and digitization.

Percent of total respondents



Source: McKinsey survey of 60 senior supply-chain executives , 2Q 2020

including digital platforms, the internet of things, automation, and AI.

Why this time is different

While many of the drivers of SCF growth are long-standing, ongoing changes might signal a structural shift in the ecosystem. Corporates, both small and large, have structurally increased their use of supply-chain finance, systematically considering how to support smaller suppliers' working-capital needs. In a May 2020 McKinsey survey, 93 percent of global supply-chain leaders expressed plans to increase supply-chain resilience, with 44 percent willing to do so at the expense of short-term savings (Exhibit 1). This could double historically low SCF eligibility and uptake levels from below 40 percent to as much as 80 percent.

Unsurprisingly then, the recent supply shock from COVID-19 led to the increased use of supply-chain financing. For instance, Prime Revenue saw growth of more than 25 percent in the number of corporate users in the first half of 2020 relative to the prior year, with the share of financed invoices exceeding 90 percent in some months, compared with the more typical 70 to 75 percent.

Supply-chain diversification as a catalyst for holistic SCF

A once-in-a-generation supply-chain diversification creates a catalyst for modern, holistic SCF solutions. The McKinsey Global Institute estimates that up to \$4.6 trillion of global exports (26 percent of the

total and up to 60 percent in industries such as pharmaceuticals) could be in scope for relocation over the next five years. This will structurally shift the ecosystem, likely in favor of players with holistic offerings across receiving corridors, whether in intra-domestic trade, in regional trade, and/or across a more diverse set of global corridors. This may result in additional support for solutions catering to the needs of domestic bank customers. Examples include Deutsche Bank and Commerzbank targeting automotive value chains.

Tackling fragmentation with digitization

Digitization resolves issues arising from fragmentation of delivery as corporates are actively focusing on their supply chains. The aforementioned 2020 survey across industries identified 79 percent of respondents planning investments in digital supply chains. One corporate executive stated that COVID-19 has forced "a change of mindset" from the historically slow pace in digitizing supply-chain activities. Similarly, banks are forced to develop truly end-to-end digital capabilities, from onboarding and application through approval and execution to improve servicing, capacity, and ability to automate underwriting and risk management.

Changing competitive forces

Many nontraditional players are aggressively targeting attractive niches in this business, threatening banks' revenue streams:

- Fintechs are developing value propositions centered on digital platforms to provide

Room for growth in supply-chain finance?

Conceptually speaking, the potential market for supply-chain finance encompasses every invoice and receipt issued by corporates—up to \$17 trillion globally (Exhibit B). In practice, however, there is a large global gap in trade finance, estimated to be \$1.5 trillion, rising to \$2.5 trillion by 2025. This estimate was forecast by the World Economic Forum before the start of the COVID-19 pandemic. The trend is likely accelerating as the pandemic and trade conflicts prompt further reshuffling and nearshoring.

To date, several practical constraints have impeded the financing of these balances:

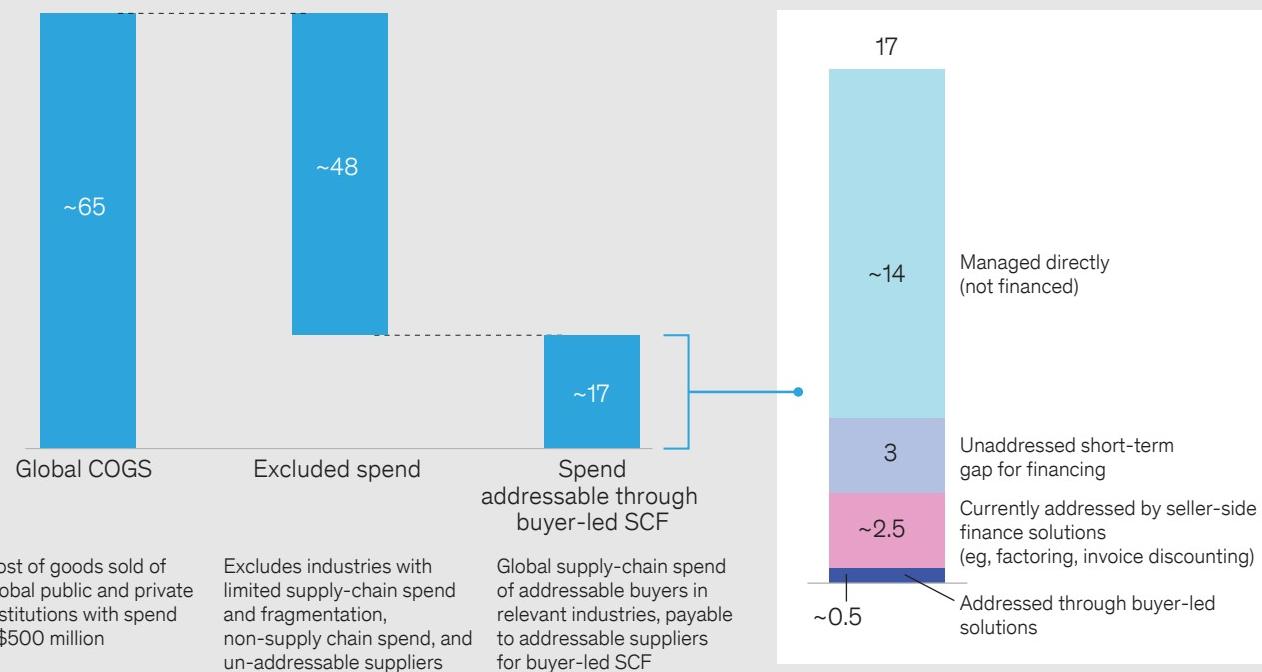
- lack of coverage of buyer-led solutions, which typically target only the largest suppliers
- manual and fragmented processes for supplier-led solutions, leading to inefficiencies that erode the business model for many financing opportunities
- inability to address invoices for non-investment-grade suppliers, less than 10 percent of which are financed

Exhibit B

There is significant room for growth in supply-chain finance programs.

Assets eligible for SCF programs

\$ trillion, 2018



Source: McKinsey Global Transaction Banking service line

non-financial services, directly connecting corporates. For instance, fintechs (e.g., US-based C2FO) are offering dynamic discounting, an innovative nonlending-based supply-chain finance product enabling buyers to make early payments to suppliers in return for a discount. Tradeshift, another example,

offers an integrated platform to large buyers and SME suppliers spanning the procurement value chain. Recent partnerships and investments in companies like these are signs that model is catching on.⁴

⁴ For example, Taulia received a new strategic funding round led by Ping An and JPMorgan, and Deutsche Bank invested in Traxpay, an SCF fintech.

- Several consortia have emerged in trade finance leveraging technology such as blockchain to make processes faster, simpler, and more transparent. Marco Polo has onboarded roughly 30 banks and offers an API-based platform for banks and corporates. Logistics company Maersk partnered with Tradelens and IBM to offer real-time, blockchain-powered supply-chain tracking and optimization via event tracking and distributed document sharing. Komgo, a consortium of 15 financial institutions including Dutch banks, trading companies, and oil giant Shell, was leveraged by MUFG to conduct its first transaction on blockchain.
- E-commerce companies like Amazon and Alibaba have moved into the SME value chain and now the supply-chain as well. Companies leveraging these solutions are generally digitally active and receptive to financing via digital workflows and products embedded in payments and process flows. Ecosystems are starting to integrate financing capabilities or partner with banks and other parties to develop such functionality, providing access to corporates previously out of scope for these forms of financing. Alibaba and Kinnek are pursuing this model in traditional B2B marketplaces, while Amazon and Predix are doing so for digital ones.

Innovative decision making

Bank and nonbank providers are innovating in credit decision making, especially through rapid improvement in the application of advanced analytics and machine learning to financing decisions and pricing. SCF platforms and banks are increasingly augmenting payables information with historic information, as well as additional private and public data to drive innovation in financing decisions. This leads to better risk pricing, but also improves speed and certainty of credit provision, two key drivers for corporate customer satisfaction and retention.

Delivering on the promise: What real change could involve

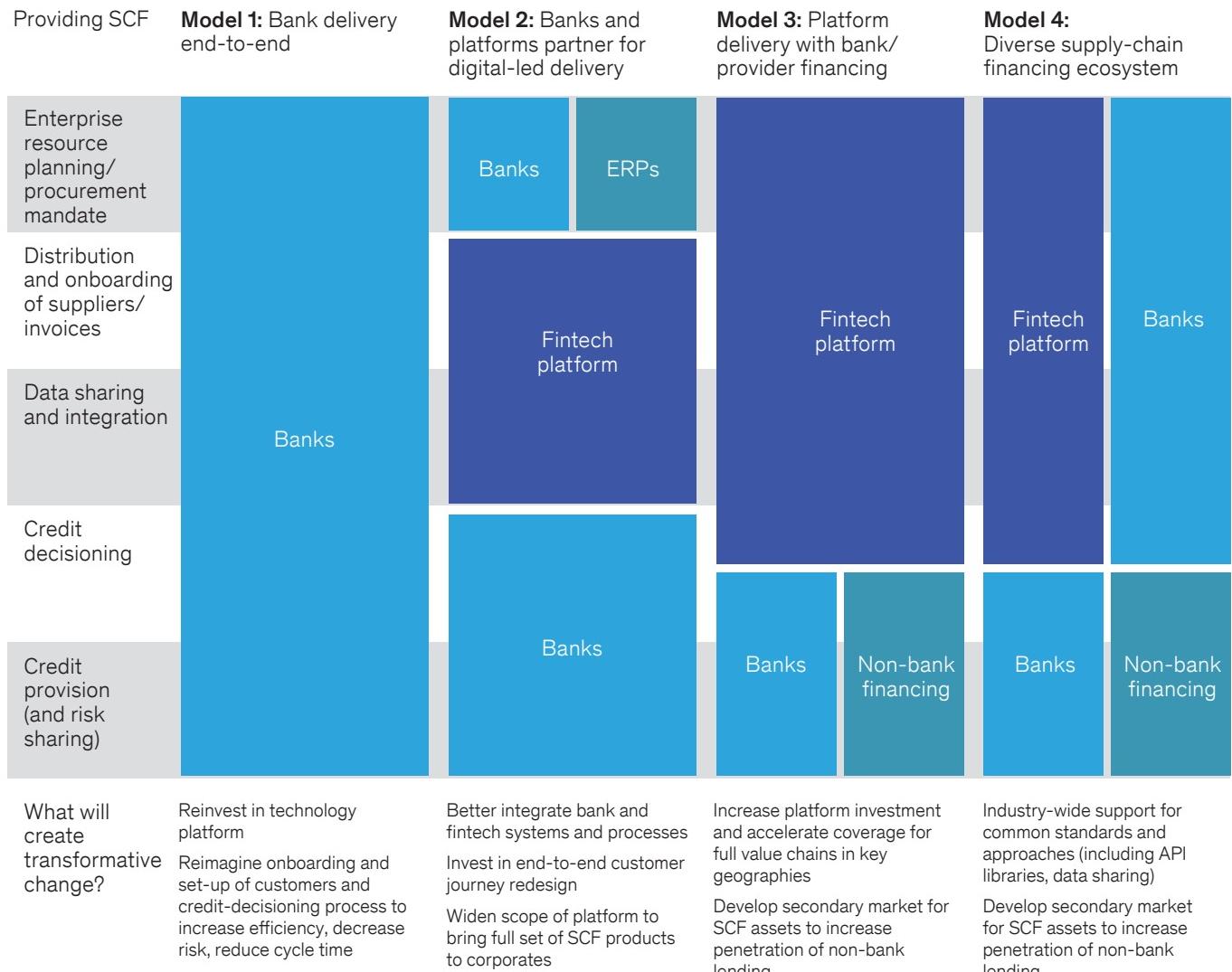
Given the persistent fragmentation of the SCF ecosystem, our view is that current converging trends will trigger a structural change as corporates accelerate their digitization of supply-chain finance and constantly assess their financing setup to fully benefit from the shifts outlined. Winning them over will likely require heavy focus on their digital interfaces. This could take the form of industry

libraries of APIs and data exchanges, or it could involve open standards to make ERP, invoice, and supplier data portable across platforms. Here are four possible future models and what each would mean for market participants (Exhibit 2):

- *Model 1: Bank led.* Banks improve end-to-end delivery by reimagining client journeys, renovating technology, and delivering AI-enabled financing. By effectively drawing upon the strength of their corporate client portfolios and established processes for credit decisioning and provision, they resolve longstanding challenges such as onboarding, distribution across the full set of suppliers and invoices, and scaling of their overall ability to provide credit.
- *Model 2: Bank-led partnerships.* Banks partner with platform providers to develop solutions (ERP integration, third-party data) but retain control of the customer interface. Banks then move beyond numerous (but often superficial) partnerships with fintech or technology platforms to create truly seamless and digital SCF journeys spanning procurement, invoice creation, and financing. This is accomplished through APIs and connectivity across suppliers and buyers in the value chain spanning digitally native, invoice-agnostic SCF platforms covering a buyer's full set of suppliers and the seller's full set of invoices.
- *Model 3: Platform led.* Nonbank platforms scale to provide SCF across the full industry value chain of suppliers and buyers, linking into banks and nonbank financing providers. They draw on established capabilities, including rapid distribution and onboarding of suppliers' invoices and platform flexibility to cater to different invoice types and SCF products and enable the platform providers to become the go-to source for invoicing data and financing. In this model, banks and other ERP platforms are reduced to serving as secondary sources and underlying "pipes."
- *Model 4: Diverse supply-chain finance ecosystem.* A broad range of providers coexist, each catering to different needs. Given existing fragmentation, we can envision a continued niche-based evolution of SCF (e.g., in e-commerce or textile distribution), catering to the full set of suppliers and specializing in credit assessment for selected industries.

Exhibit 2

There is room to accommodate multiple future SCF market models.



Source: McKinsey Global Payments Practice

Platforms could build out digital, easy-to-use, self-serve management of invoices for SMEs, aggregating the range of SCF products and financing sources.

Platform-led models and diverse supply-chain finance ecosystems are more likely to be multi-bank compared to the current, typically single bank-led models. Multi-bank models allow wider solution penetration across various corridors and customer segments and, by definition, create some solution standardization. They require more effort to implement, however, and finding an approach

that satisfies multiple banks' requirements is not a trivial matter. In determining whether to join multi-bank efforts, banks should assess the benefits and risks, including the trade-off of increased scale and reach vs. distinctiveness of the offering. This is especially relevant for those who consider supply-chain finance a differentiating feature for their corporate customers.

Now for the hard part

As highlighted, the existing trends around digitization, platforms, and finance provision

are supercharged by COVID-19. Of course, the underlying growth drivers of SCF will remain intact, even if selected niches, particularly along some corridors, are affected by economic or geopolitical developments. Overall, while corporates will benefit from increased, more seamless, and likely cheaper access, this is a fundamental threat for banks. In either case, the likely next phase will see significant shifts between banks and toward nonbanks.

Banks now need to decide whether to fight for a share of a much-expanded bank-led model or whether a retreat is more likely. It is likely that only a few large banks will be able to provide all services described and effectively compete in the bank-led model 1. In servicing their customers, they would need to draw on learnings from fintechs and platforms, e.g., by reimagining onboarding to reduce cycle times to approval by 90 percent while increasing adoption rates, or by fully automating credit decisions. This entails heavy investment in technology, expanded breadth of services, and broad customer reach.

More likely, most banks will need to trigger a shift into the bank-led partnerships of the second model listed. In this scenario, banks would no longer need to be the end-to-end provider of SCF products. For customers in given verticals or for selected steps of the value chain, banks may elect to enter partnerships with other providers to achieve scale and reach. This is likely the default mode for many banks and is particularly suitable for regional and smaller players. However, it still requires significant focus on partnerships, integration, and digitization, as banks will need to scale quickly and accelerate their partnerships—not only with fintechs or other technology players, but also with each other in order to gain scale. Success in this model cannot be achieved alone: banks should foster the development of a secondary market for SCF products, as well as initiatives to enable the financing journey, including common standards for data sharing and API integration.

Meanwhile, platform providers should aim to displace banks at scale in a platform-led model. It requires them to scale coverage across several key value chains (e.g., major automotive suppliers in North America, major textile intermediaries in Southeast Asia), integrate a broader range of

financing providers to cover the full set of invoices, and develop a secondary market for SCF assets to increase penetration among corporates. They will likely need to link into banks as sources of funding. Particularly for smaller banks, this may appear to be an attractive route to generate income without building an SCF engine. It is possible that large e-commerce orchestrators (such as Alibaba and Amazon) will coalesce into this model over time and gain significant SCF market share, particularly in serving SMEs. Other providers, particularly fintechs and consortia, will likely have a tougher time achieving scale but should not be counted out, as they can always partner with bigger players or banks.

All said, we expect this will not be a “winner takes all” market and that different solutions will co-exist in the future landscape. There is sufficient market breadth for multiple networks, technologies and business models to succeed. A comparison can be seen in FX trading market automation, where mono-bank, multi-bank and network solutions have evolved to address historical inefficiencies. Even in the multi-polar model, however, participants will need to focus heavily to retain and potentially improve their positioning.

It's worth noting that the past decade has been a period of persistent economic growth and relatively stable supply chains. Volatility will cause much greater market turbulence. This pressure may be felt most strongly among banks that did not focus their sizable SCF franchises in recent years. Time will tell whether their stand-alone status proves to be a sustainable model or—more likely—drives corporate customers to other SCF providers. In the end, a multi-trillion-dollar financing opportunity is at stake.

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The authors would like to acknowledge the contributions of Pavan Kumar Masanam to this chapter.

A burning platform: Revamping bank operating models for payments

The payments segment is performing well for banking—but not for banks. Under pressure from multiple forces, successful banks will develop a new operating model better suited to changing times.

Olivier Denecker

Payments remains among the best-performing financial-services product segments around the globe. Despite the direct impact of COVID-19-related lockdowns, leading payments players have rebounded surprisingly quickly, and many aspects of commerce resumed relatively uninterrupted in most regions almost as soon as lockdowns were lifted. Payments providers' central role in the economy—and their business potential—is illustrated by their healthy total shareholder returns (TRS) even amid the economic downturn (Exhibit 1).

Although some segments of the payments industry—including travel-related services, international remittances, and specialty integrated point-of-sale solutions—face deeper and longer-term impact, digital payments volumes have soared overall, partially driven by accelerated consumer migration to digital channels and payments forms. This momentum is expected to persist as a next normal develops.

Unfortunately for banks, historically the main providers of payments services, this momentum does not extend to most of them. Traditional revenue sources, such as interest margins on current accounts, revolving credit lines, interchange revenues, and cross-border fees, are under pressure in the current environment. Interest rates are at historically low levels globally and are not expected to rebound soon. Credit-card losses are exacerbated by the economic downturn. And interchange and cross-border payments fees

Yaniv Lushinsky

are pressured by regulation and competition. As a consequence, the bank side of the payments revenue model has substantially declined over the past year, especially because of compressed net interest margins and attrition of bank-specific fees such as interchange. Recovery is not imminent.

Albion Murati

Jonathan Zell

In a highly competitive market where it remains difficult to charge substantial transaction fees, the payments P&L outlook for many banks is challenged in the near to midterm, absent significant cost rationalization. Success for banks will depend on thoughtfully assessing capabilities, determining the role of payments in market strategies, and appropriately aligning payments operations to achieve the required performance improvements. More than traditional cost optimization, this may involve unit carve-outs, payments as a service, outsourcing, and/or partnerships to ensure appropriate performance.

Investment needs challenge banks' ambitions

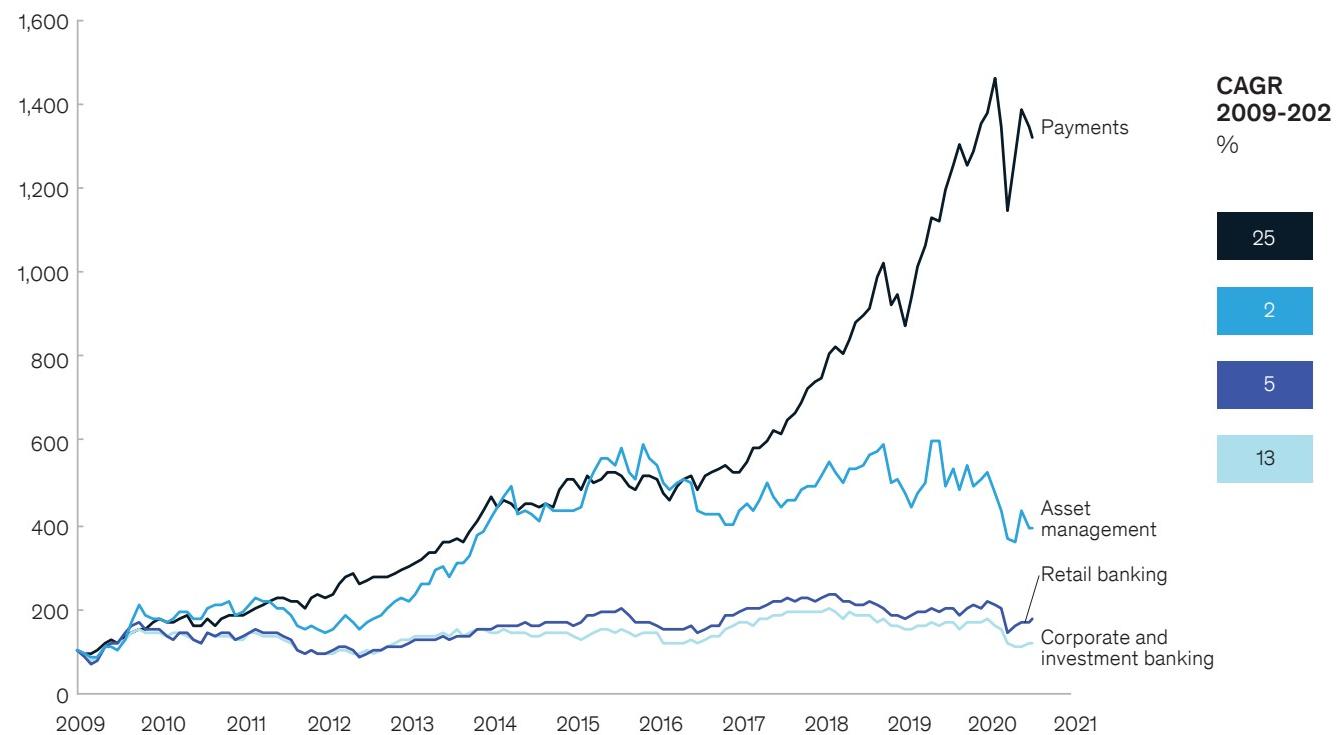
Payments remain a substantial factor in banks' operating cost base, sometimes representing as much as 30 to 40 percent, partly because of the high technology spend associated with providing payments services. A disproportionate share of effort and resources is required to maintain and improve infrastructure, manage upgrades, implement rule changes, and rationalize legacy technology. This often leaves insufficient resources for sorely needed digitization efforts and investment

Exhibit 1

Payments companies continue to outperform other banking sectors in value creation.

TRS performance of public companies¹

Indexed to 100 = January 2009



¹ Based on an analysis of public companies; custom indices (market-cap weighted) based on identified public European peers: payments N=27, retail banking N=20, asset management N=17, corporate banking N=5; 2019 data as of October.

² TRS CAGR for Jan 2009-July 2020.

Source: S&P Capital IQ; McKinsey analysis

in new customer services and applications. The complex nature of integrations between payments and many other bank systems add to the cost of change.

All signs point to the expectation that for banks, the cost of ownership of payments services will remain high, given the ongoing number of regulatory, IT, and market-driven sector changes (e.g., instant payments, open-banking adoption, PSD2—and perhaps 3—proliferation of alternative payments methods). The majority of these investments focus on staffing supporting projects, ensuring compliance with external requirements, and shielding the customer experience from disruption, rather than freeing up capacity to allow banks to develop new products and enable new customer experiences.

However, given that payments represent the most frequent touchpoints between a bank and its customers, the need for digital investment to remain competitive also is growing. In the context of lower bank payments revenues, concern is increasing over the ability of leading banks to continually harness the capital resources required to pursue market leadership, particularly given the demonstrated investment capabilities of the leading nonbank payments specialists.

COVID-19's impact on the top and bottom lines of bank P&Ls (including payments) and the need to continue investing in technology to offer a compelling value proposition require banks to determine the strategic role and their level of ambition in payments. While some banks view payments as a differentiating factor, others do not

see their payments value proposition as a core component of their unique product offering.

Given the industry's rapid evolution, payments leadership requires the willingness to commit significant investment. As a point of comparison, leading payments specialists each committed between 3 and 13 percent of their revenues to capital expenditures in fiscal year 2019, representing annual budgets ranging from \$250 million to nearly \$1 billion. While a "fast follower" strategy to capture real growth—for instance, by casting one's organization as a disruptor or service champion at a lower price tag—certainly has appeal, it too places added requirements on the operational capabilities and systems of banks and still triggers the need for investment.

In this context, the one truly negative option is to do nothing in the face of market upheaval. Whatever role payments play in a bank's overall strategy, the industry's rapid changes coupled with the increasing investments required to play in this space require banks to rethink their payments operating models.

Changing the operating model: Four options

Today, for banks to retain their central position in customer journeys and the payments business, they will need to reflect on the fundamentals of their operating model. Incremental efficiency gains will no longer be enough to maintain banks' structural advantages in the space. We believe cost improvements of 30 percent or more will be needed for banks to create the necessary headroom for investment and acceptable profitability. And although that target might seem daunting, we believe it is within reach.

The urgency to fundamentally rethink the payments operating model is heightened by the confluence of several market factors. These are increasing pressure on margins; growing international standardization, enabling potential scale gains and the emergence of technologies supporting change; and growing regulatory pressure to revamp operations to enable services like instant banking and open banking.

But change to what? Four potential operational models, each with appeal to banks facing particular strategic circumstances, offer potential. These are a carve-out and scaling of payments, a partnership to share payments utilities, offers of

payments as a service, and outsourcing of selected payments services.

Carve-out and scale-up

In certain cases, a payments business operating within a bank organizational structure may suffer from underinvestment and lack of scale. This condition may result partly from serving a small set of internal customers and partly from the absence of an outward payments market focus. In such cases, banks should consider whether a carve-out and scale-up of the payments business, operated as a separate P&L, may create more value for customers and other stakeholders.

As payments services commoditize and margins contract, payments businesses need to drive scale quickly to reduce per-transaction cost and improve profitability profiles. That can be difficult to accomplish within a bank structure, as payments services are mostly limited to bank customers. Treating payments as a stand-alone entity allows for the expansion of services to other banks and direct offers of services to a broader array of customers, thereby driving scale and improving profitability. A successful carve-out will also empower entrepreneurial leadership within the new entity, which can prompt development of new skills and create an appetite for growth.

Eventually, this approach typically enables greater investment in the business and introduction of more innovative and value-added services to customers than a purely in-house operation would likely have achieved. It's an appealing strategy for banks that view payments as an operational strength and a competitive differentiator; it can further bolster these advantages by driving additional investment. Carving out the payments business enables a more flexible approach to growth while also establishing a currency that makes subsequent consolidation possible, as carve-outs can tap into the higher valuation afforded payments companies. Historically, the carve-out of Worldpay from RBS in the United Kingdom and the carve-out of Vantiv from Fifth Third Bank in the United States are key examples of how value in payments can be generated through carve-out and scaling of the payments asset.

Shared payments utilities

Banks can consider partnering with one or more peers to establish shared payments utilities that improve and expand upon services provided to their joint customer base while reducing the investment

that would have been required if each bank had developed the solution on its own. Such pooling of resources and coordination between consortium members leads to the development of superior payments products with a higher probability of wide-scale adoption, enabling banks to win customer relationships and protect them from nonbank payments specialists.

By nature, sharing payments utilities limits banks' opportunity to differentiate based on product features. Therefore, the strategy is best suited for products benefiting from a common core feature set and/or institutions looking to compete based on service, rather than banks with the objective of being a "payments leader." In addition, banks can still differentiate from other banking players by leveraging the shared utility to introduce innovative solutions or address specific use cases not offered by other banks. For instance, a real-time-payments (RTP) scheme can be developed as a shared utility but allows each bank to develop unique RTP use cases for different customer segments.

Examples include the establishment of electronic alternative payments methods that have helped reduce merchants' payment costs. A consortium of banks established P27, a pan-Nordic real-time payments scheme, while six large Swedish banks, in cooperation with the Central Bank of Sweden, launched the mobile payments platform Swish. Neither of these undertakings would have been likely to gain sufficient scale if it had been approached independently by a single bank. Similar shared-utility opportunities exist in national debit schemes and in joint know-your-customer (KYC) and fraud-prevention initiatives.

Payments as a service

While outsourcing of the full payments stack is a possibility, a new generation of technology providers has emerged allowing banks to expand quickly and modernize their payments product portfolio without incurring high upfront investment. Payments-as-a-service (PaaS) players operate cutting-edge cloud-based platforms to provide specialized services, such as card issuing, payments clearing, cross-border payments, disbursements, and e-commerce gateways.

Banks wishing to offer these services can integrate these platforms via application programming interfaces (APIs), which allow the institutions to link these products into their core banking platforms, in effect building a cloud-based payments services

stack of their own. Banks can then offer these services to end customers and can update and swap out services more readily. The ability to rapidly add or replace specific solution providers is key to this model, as it allows the bank to realize the "fast follower" vision of capitalizing on best-of-breed solutions. Therefore, it is essential to confirm that such plug-and-play interchangeability is truly attainable.

This allows banks to enjoy several advantages. First, they can expedite time to market for new payments products—say, launching a new credit-card program in two or three months rather than two years. They also can reduce capital investment; instead of building a credit-card stack in-house, they pursue a much simpler integration with the cloud platform. In addition, they can ensure that products are continuously updated and upgraded without disproportionate maintenance investment, since the PaaS partner handles platform maintenance and upgrades, ideally in collaboration with bank product leaders. Finally, they can forged a stronger link between cost and revenue, since the majority of PaaS fees are transaction based and/or based on API usage.

Prominent institutions have adopted this approach. JP Morgan recently partnered with Marqeta, a PaaS card issuer, for virtual commercial credit cards. Oxbury Bank has chosen to work with ClearBank, a PaaS payments clearing and agency-banking provider, to clear its UK wholesale payments.

Outsourcing

Banks that do not wish to—or cannot afford to—invest in building or upgrading a full payments technology stack can still offer best-of-breed payments products to end customers by outsourcing select services. This approach is applicable to a variety of services, including merchant acquiring and processing (especially for small and medium-size enterprises [SMEs]), cross-border payments, B2B payments, and card issuing.

Outsourcing enables the rapid expansion of service breadth, even for banks unable to justify the cost of developing the service in-house. Banks can mix and match to create a broad suite of payments services suited for their customers. While outsourcing leads to some loss of control over product and service quality and can inhibit the marketing of a holistic, integrated product portfolio, banks do retain control over critical customer touchpoints and, in many cases, valuable transaction data.

Although large banks like Chase in the United States and Lloyds in the United Kingdom offer their own merchant acquiring and processing solutions, many other large brands rely on external providers to support their SME merchants payments needs. Transferwise now offers remittance services to banks, a solution that reduces the cost of operations for cross-border payments and often expands payment corridors offered to customers for banks lacking global reach.

Banks also have the option of a full outsourcing of their payments stack. Many smaller US institutions have done this with players like Fiserv. In Europe, Commerzbank and UCI have done this recently with Worldline.

Moving to a decision

Changing the operating model of a business that typically represents one-quarter to one-third of the bank's business is difficult (see sidebar, "Lessons from experience"). Nevertheless, for most banks, it is a necessary step to ensure long-term success in a critical and rapidly evolving market.

Deciding on a bank's future payments operating model first requires determining the bank's level of ambition in payments. Bank leaders should

ask themselves what is critical to their bank in the payments arena. Is it strategically important to retain control of customer touchpoints and data, or is it enough simply to ensure provision of a full suite of essential payments products? Which payments products and services are critical to differentiation? Is the bank meeting this desired standard today?

Given the high investment required to lead in payments in the future, banks should also take a brutally honest look at their current level of payments capabilities and consider these questions: What is our stand-alone potential for improvement? What are the bank's realistic prospects for in-house development and innovation, including its ability to earmark sufficient investment funds?

For banks that are ambitious in payments and at a solid starting point in terms of in-house payments capabilities, we consider carve-outs of the payments business as a potential development for the mid- to long term. Carving out the payments business could create long-term value by attracting top-notch talent free of the constraints of banking labor agreements, creating a clearer path to scale by attracting other banks' volumes, and building out stand-alone operations in an environment that generates high-multiple valuations.

Lessons from experience

We reviewed our experience with outsourcing, utility, PaaS, and carve-out operations to uncover a few lessons that banks should consider applying when choosing a new operating model:

- Convincing the bank to outsource operations can be difficult and requires a strategic discussion at the executive level from day one. Continued executive involvement will be necessary to keep the process from stalling in operational layers of the organization.
- Understanding the bank's interest and pain is the key. Services that do not address a specific pain point are mostly irrelevant.
- Decisions about which services to provide must weigh provider capabilities and identify where the providers can outperform the market.
- Options can—and in many cases, should—include legacy and low-margin services. Creating a value proposition in these spaces is often more beneficial than pursuing innovations.
- Assuming the bank intends to scale the service beyond an initial set of clients, it should pursue easy integration and management of a variety of interfaces.
- Decision makers might need to consider different types of providers to obtain the required value proposition. Multiple types of partnerships may be necessary for acquiring the needed scale.
- Building commercial capabilities in payments may involve either building an in-house sales force or partnering with outside providers.

If the bank lacks the investment capabilities required to keep pace with the competition or hasn't committed to being unique in its payments offerings, an attractive alternative is to investigate the wide array of available outsourcing plays. A full complement remains incomplete in many markets outside the United States, however, although some players are developing in this space. Before choosing which route to take, banks should ask themselves several questions: What scope of partnering and outsourcing is my bank willing to consider, and in which areas? How much cost savings could be gained from each outsourcing option? Is there a reliable payments supplier in the market to outsource to, or is there a need to build a common utility? What will be the impact of the transaction on my HR and social situation? How would the bank mitigate associated risks, ensure

sufficient input in future product decisions, and retain flexibility for potential future changes?

Whatever level of ambition and starting point in payments a bank may have, now is the time for its leaders to take a close look at its payments operating model. With several options available, strong players are already creating the new generation of payments. Those that cling to old ways will be left behind.

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Closing the gap: Matching attackers on B2B sales for SMEs

In times of crisis the most resilient players gain disproportionate benefits. Innovating and offering better products are important, but not enough to realize the full gains. In a highly competitive market such as the small and medium-size enterprise (SME) space, the ability to structurally enhance sales capabilities through advanced analytics is paramount for providers of payments services.

Maria Albonico

The increasing digital sophistication of SMEs and the impact of COVID-19 on technology adoption and ecommerce have heightened the need for payments providers to offer more advanced yet easy-to-use solutions, while simultaneously expanding into adjacent sectors to create broader offerings enabling a straightforward, customer-oriented delivery model.

The challenge for payments acquirers aiming to compete in the SME market is two-fold: the disparate needs of various segments, and rapidly changing channel preferences. The result is that the segment is often perceived as “difficult and costly to serve.” Legacy providers should explore the potential of advanced analytics and revamped distribution approaches as avenues to successfully and profitably serving this sizable market.

While SMEs have been gaining in technological sophistication for several years, the current crisis has emphasized and accelerated two trends:

1. SMEs have recognized the importance of technology to solve both short- and long-term needs, therefore are accelerating adoption.
2. E-commerce has become an operational imperative rather than a “nice to have.”

In this context, nonbank payments companies have rapidly emerged as go-to partners for SMEs, fueling digital transformation through high-tech solutions addressing payments needs and beyond.

Nunzio Digiocomo

What an SME client values varies significantly based on their size and digital channel penetration. For example, a small physical merchant may require an excellent in-store payment experience and integration with store management platforms.

Multichannel players, on the other hand, may prefer a seamless customer journey integrated across all channels and devices, along with loyalty, customer engagement, and marketing services. Purely digital SMEs typically need an all-in product suite for the most effective and seamless experience, with special attention to tools and analytics to increase conversion (Exhibit 1).

From a distribution perspective, the landscape is likewise heterogeneous, with go-to market models spanning from purely digital and self-serve to in-person direct and intermediated models relying on account service providers.

SME needs differ substantially from those of larger corporates in terms of user experience, the latter typically requiring higher levels of personalization and differentiation, as well as physical coverage, while SMEs prioritize features such as self-serve access, simplicity, and consumer-centric interfaces.

Traditional banks and merchant acquirers often face barriers that limit SME market success. They frequently rely on “one-size fits all” distribution models with little differentiation for merchant size or sophistication level. They only seldom leverage technology at scale either to improve distribution

SMEs present different needs according to their channel strategy.

SME distribution model	Main needs	Example offerings
Purely digital Companies with fully digital business model (eg, ecommerce-only players)	All-in-one suites for payments and customer journeys to deliver seamless digital experience	In-app payments Subscription-based payments Tools and analytics to increase conversion
Multichannel Companies with both physical and digital channels (eg, wine producers)	Integration of experience across all channels for seamless customer journey	Marketplace integration Omni-device payments integration Integrated customer engagement, loyalty, CRM
Physical Local companies with only a physical presence (eg, corner stores, taxis)	Integration with ERP and inventory management Working capital financing	

Source: McKinsey analysis

channels—instead leaning heavily on outbound phone calls and inbound branch visits—or to use advanced analytics (only a few players have adopted machine-learning models to spot opportunities for cross-selling and for preventing churn). Many traditional players also appear reluctant to leverage partnerships to complete their product offering. On the other hand, attackers like Square, Stripe, or Mollie have rapidly advanced from offering a single innovative service to building integrated ecosystems of differentiated high-tech products powered by partnerships and analytics.

Distinctive and innovative product offerings, integrated across the value chain and designed for an exceptional user experience, have become necessary to compete with digital attackers, but products alone are not sufficient to win the SME market. They must be combined with a superior service model and effective use of analytics to enable simple and differentiated pricing models.

Acquirers seeking to innovate in the SME segment must establish effective direct distribution of products with self-serve access through digital channels. Acquirers relying on distribution models intermediated by universal banks should also ensure

their sales force is equipped with the support materials and training they need to enable SMEs to realize the potential of the products offered.

A successful low-cost distribution model combines the digital and physical to create a compelling customer journey

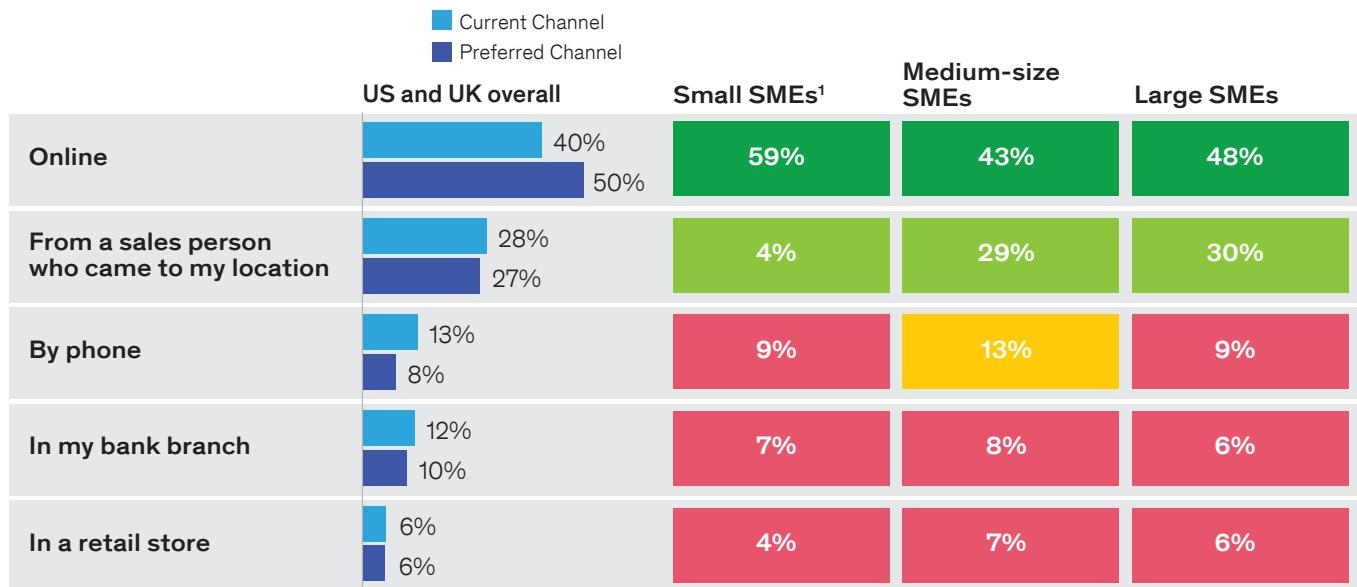
A fully digital distribution and service model is uncommon among banks and incumbent acquirers, but can be the key to tapping into multiple levels of customer excellence. Best practices include automated, rapid onboarding, webshop setup, simple user experience, and easy post-sales data reconciliation.

Even for traditional payments acquirers, effective use of digital channels and partnerships is key to winning in the SME market. In fact, online is the preferred channel for purchasing payments for SMEs, while physical stores and branches are the least preferred, closely followed by the phone channel (Exhibit 2).

Due to the increasing technical advancement of payments products and the growing opportunities for cross-selling, SME service models are also shifting from a reactive to a proactive stance, continuously offering new products to answer

Online channels expected to supplant phone and in-person for SME sales.

If you had a choice, how would you prefer to purchase payments products and services?
 % respondents selecting answer



¹ Revenues: small (\$0-\$2.5M); medium (\$2.5M-\$50M); large (>\$50M). US and UK overall, N=1,109; small, N=366; medium, N=322; large, N=331. Source: McKinsey Merchant Survey of 1,000+ merchants in the US and the UK in 2018.

evolving company needs. While depending on geography and economics, human-based first sales and renewals may still be acceptable, including leveraging partnerships with platform players and cash register/enterprise software providers, cross-selling should be done mainly through direct channels with self-serve access. Day-to-day customer service activities can also be handled mainly through self-serve access tools, with physical specialized coverage reserved for the most valuable clients with the most complex needs.

UK payments fintech SumUp, which offers portable and user-friendly card readers to small merchants, has partnered with customer service provider Solvedmate to design an AI-powered chatbot enabling merchants to receive assistance through a direct channel and scale up their customer service. The chatbot has achieved a 72 percent resolution rate (no further interaction required), allowing the firm to reduce demand for agent assistance by 22 percent.

Advanced analytics and effective sales are keys to increasing revenues and retaining customers.

Accessible technology and increasing demand for payments solutions have enabled new players

to enter the payments landscape, competing on pricing and innovative solutions. Digital attackers are creating products that are easy to use and setup, satisfying the most important buying factors for B2B payments products. They have also developed advanced products at competitive prices, making a compelling case for companies to switch payments providers (Exhibit 3). Furthermore, the current challenging economic environment is applying existential pressure on many SMEs, creating even greater price sensitivity for payments services.

In this context, accurate segmentation of the SME customer base is crucial. Advanced analytics can play a substantial role here, improving pricing, cross-selling, and retention. For example, a large acquirer with a history of non-standardized pricing with little differentiation and infrequent adjustments, and a merchant population widely varying in profitability, boosted revenues by roughly 17 percent with a pricing strategy combining traditional commercial excellence levers with advanced analytics. These results were heavily reliant on machine learning to segment customers based on target margin and churn propensity. The segmentation enabled improved execution of more-for-more (MFM) repricing, targeting merchants

SME merchants demand ease of use/setup, and are willing to change providers for better prices and technology.

Which buying factors are most important when choosing between products/solutions?

% respondents selecting answer

Ease of use. Product/service is easy to customize (eg, applications), has minimal downtime, etc

57%

Ease of setup. Product/service set up is straightforward, is done quickly, and does not disrupt business

44%

What are the main reasons that would lead your company to change payments service vendor?

% respondents selecting answer

Other vendors offer a better price

39%

A better technology is available in the market (eg, faster, easier to use)

34%

Source: McKinsey Merchant Survey of 1,000+ merchants in the US and the UK in 2018.

below their segment's target margin and with low churn propensity. The repricing was implemented in three waves per year and paired with detailed and effective communications conveying the benefits.

The acquirer also developed an analytics model that could extract true churn signals in order to identify SME customers at high churn risk that should be excluded from repricing (and enabled the acquirer to take actions to win those customers back).

Advanced analytics can be also used to optimize subscription payments, including boosting digital collections. Card expiry is one of the most vexing challenges for merchants in retaining customers, given cumbersome legacy processes to update cards on file. A number of companies in the market automate payments credential updates, leveraging algorithms to reduce customer churn.

Finally, advanced analytics can help uncover cross-selling opportunities with existing clients. For example, website traffic data can be used to update client dashboards, automatically recommending upgrades to a plan or other products. Companies

like Cardlytics and Affinity offer white-labeled services that help financial institutions and merchants better understand their customers and target them with actionable offers.

Swedish bank Klarna provides an array of financial services extending beyond payments for online storefronts, and uses advanced analytics to increase sales while minimizing financial risks. Klarna has created accurate algorithms based on millions of purchase events gathered over time, enabling their Pay Later service (post-purchase payments in which Klarna assumes all financial risk of customer non-payment) to deliver the market's highest acceptance rate and near-immediate purchase approval.

Kabbage also offers to support cross-selling opportunities. Its advanced analytics models support the micro-segmentation of SME clients based on their needs, and the creation of bundles of products addressing each microsegment, including value-added services like business and competitive insights and merchant financing based on billing

trends. Kabbage has a fully automated platform that enables underwriting decisions in under seven minutes, leveraging real-time data from sources including social media, payments data, orders from ecommerce platforms, and shipping info to assess company risks.

While advanced analytics can help spot cross-selling opportunities through customer micro-segmentation, the extensive use of digital marketing paired with enhanced sales and technology capabilities and a systematic approach is what converts those opportunities into recurring revenues and fuels success (e.g., state-of-the-art digital sales channels with sales teams comprised of tech-savvy salespeople and/or technical resources with customer-facing experience, relying on systematic sales routines with a successful track record).

Human-based sales are still relevant in certain geographies and economies, and can even be turned into a competitive advantage against attackers that rely solely on digital channels. But human-based sales need to be supported by superior technical knowledge that helps SMEs realize the full potential of modern payments solutions, and a systematic approach to converting leads into new customers. Traditional banks and acquirers relying on in-person sales but lacking specialized salespeople and effective sales routines must rapidly catch up to compete with the state-of-the-art digital attackers. A major European bank successfully implemented a sales network capability program, achieving significant results in terms of products sold (increase of 20 percent), customer satisfaction (a nearly nine-fold NPS improvement), and employee satisfaction (up 27 percent). The program was largely designed from the bottom up, leveraging the involvement of top-performing employees and sales leaders to build capabilities through workshops and trainings; it also involved the use of a multichannel viral communication to foster adoption of sales best practices and routines.

Three imperatives for capturing SME market share

While digital attackers are gaining scale and price pressure is increasing, the evolving needs of SMEs create unprecedented opportunities for payments providers. Three important imperatives for success:

- **Understand SMEs in depth.** Leverage internal and external data to segment SMEs based on their specific needs, and models that improve pricing, spot cross-selling opportunities, and predict customer churn.
- **Give SMEs what they need.** Develop product offerings (e.g., bundles of payments and non-payments products and services) that answer the specific needs of each segment, leveraging partnerships and focusing on ease of use and intuitive setup.
- **Let SMEs serve themselves, but deliver knowledge when they need it.** Set up direct channels with self-serve access tools for cross-selling and day-to-day service activities, while increasing the technical knowledge and effectiveness of the salesforce.

These actions require investments in new technologies and capabilities, but these investments can be well worth it. The SME segment is more attractive and essential than ever, and may represent a key success factor for acquirers going forward.

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